HARVARD BUSINESS REVIEW

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The Commodity Dollar
The French Franc
Leadership within Industrial Organizations
Executive Compensation and Corporate Earnings
The Sugar Industry
Books: The Business Cycle—Economic Institutions

WINTER NUMBER
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HARVARD BUSINESS REVIEW

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THE COMMODITY DOLLAR

BY M. C. RORTY

THE recent decline in the gold value of the dollar came about by successive stages during the latter part of 1933, and became finally determined by the Presidential proclamation of January 31, 1934, which fixed the gold content at 59.06% of its former amount, and established the present price of $35.00 per ounce for fine gold.

The suspension of gold payments on March 6, 1933, while brought about primarily by domestic gold withdrawals and hoarding, had a further partial justification, at least, in the major disturbances in international exchanges which had resulted from the world crisis. If such suspension had continued along the lines of the present British practice, with efforts only to prevent sudden and wide fluctuations in the value of the dollar in international exchanges, the "commodity dollar" would have remained a matter for continuing theoretical discussion. However, the revaluation of the dollar at 59.06% of its old gold content was urged, and avowedly undertaken, in the expectation that commodity prices would respond quickly to such change, with the result of reëstablishing that 1926 level of prices which was looked upon as "normal." As the result of this action, the commodity dollar has, therefore, passed from the realm of pure theory to that of current practice, at least in so far as we now have an opportunity to observe the effects of a single act of reduction of the gold content of the dollar in times of depressed price levels and business activity.

In its essentials, the commodity dollar assumes that stability in the average of a group of prices represented by a selected price index will be maintained by variations in the equivalent of such dollar in terms of the media employed for the settlement of international balances. For purposes of discussion, it will simplify matters to think of gold bullion as such medium, since the principles will be the same with either a gold or a bimetallic, or even a symmetallic, base for international settlements. It will further sim-

plify our analysis of the problem to examine separately the applications of the commodity dollar to (a) the relief of business depressions, and (b) the prevention of such depressions, with consideration under each heading of its relations to stability in international trade, exchanges, and price levels.

The Basic Contentions—Pro and Con

Before entering upon this analysis, we may clear ground by considering the major differences which exist between the proponents and the critics of the commodity dollar.

The critics of the commodity dollar recognize that a reduction in the gold content of the currency will, in due course, be reflected in higher commodity price levels. They agree, also, that such changes will have rather prompt reactions on articles and commodities of international trade. But they contend that similar reactions on the general domestic price level will be very indirect and gradual, and will tend to become effective in terms of years rather than months.

This difference of opinion as to the rapidity with which commodity prices will respond to decreases in the gold content of the dollar is fundamental. Both critics and proponents of the commodity dollar agree that there are direct relations between the volume of money transactions, the volume of trade, and the general price level. They also agree that, whatever the influences may be which affect the actions of buyers and sellers, the immediate cause of any rise in prices must be a greater willingness of buyers to buy than of sellers to sell at current price levels—and *vice versa*, for price declines.

Here, however, the agreement ends. The critics of the commodity dollar insist, first of all, with entire correctness, that the equation of exchange—the parallelism between the total of monetary transactions and the product of the volume of commodity and other movements into the related general price level—states nothing more than the obvious fact that the sum of all purchases must equal the sum of all sales, and proves nothing whatever as to cause and effect relations in the raising or lowering of prices. They contend, furthermore, that the actual cause and effect relations, which determine variations in supply and demand, and in prices, differ in various phases of business expansion and contraction and as between short-term and long-term effects. Specifically they argue, from recent and prior experience, that ease of credit, whether brought about directly by the operations of the Federal reserve banks, or indirectly by reductions in the gold content of the dollar, will operate to increase business activity, demand, and prices only during periods when prospects of business and industrial profits are such as to lead to an actual increase in borrowings by business and industrial enterprisers. Their contention is, therefore, that monetary and credit changes, tending toward higher price levels, will become quickly effective only during periods of active business expansion, and that, at other times, the response of domestic price levels to such changes will tend to be slow and irregular.

As against these contentions by its critics, the proponents of the commodity dollar offer little in the way of indications as to the specific reactions and transactions, step by step, through which changes in currency values will become effective as changes in supply and demand, with resulting variations in price levels. For this reason, the present article attempts to apply recent

specific experience, as well as general theory and practice, to an analysis of the reactions between prices, general business activity, and changes in the gold content of the dollar.

Commodity Dollar during Depression

To begin with certain general and theoretical considerations bearing on the efficacy of the commodity dollar in relieving business depressions, it is necessary, first of all, to emphasize an obvious, but frequently neglected, distinction between the typical gold standard and the commodity dollar. Under the gold standard, the government itself establishes an unlimited market in which gold may be bought or sold at a fixed price. Under the commodity dollar, on the other hand, while the market for gold is still substantially unlimited, its price is assumed to vary by successive small steps, up or down, from period to period. Furthermore, whatever commodities may be chosen as the base for the dollar, with the expectation that the index of prices for such group will be maintained at a fixed level, or with only minor and temporary variations, the government, it is assumed, will make no commitment to buy or sell such commodities, but will rely solely upon natural or artificially induced variations in commercial supply and demand to bring about the desired price stability.

The preceding differences between the typical gold standard and a multiple commodity standard are of controlling importance. As a monetary base, gold has several special advantages outside of compactness, durability, and high value for a given weight. It is in relatively small demand for nonmonetary purposes, but nevertheless is desired and valued by practically all populations. It has been, and may continue to be, subject on the whole to relatively gradual changes in the technique and labor costs of production. And, particularly when monetary requirements are such as to justify recourse to "reef" and other low-grade deposits, rather than to high-grade secondary deposits as the major source of supply, its output, if not restricted by special taxation or otherwise, will tend to expand rapidly with a decline in costs of production (*i.e.*, with a decline in the gold levels of commodity prices and wages) and to contract with somewhat similar rapidity when costs of production rise. These several factors combine, perhaps, to give gold certain inherent advantages over any single base for currencies.

As contrasted with the use of gold as a base, we may begin our analysis of the multiple-base commodity dollar by assuming, first, the substitution of a single commodity in widespread commercial use. To simplify the problem still further, let us choose an article, such as common brick, which does not enter appreciably into international trade and, as an item of construction materials, is subject to wide variations in demand.

On this basis, let us assume that the price of 70 bricks at wholesale is to be maintained at one dollar, and that the gold redemption value of the dollar is to be varied in such manner as may be necessary for this purpose. If the price of bricks is to be maintained at 70 per dollar, the immediate requirement, as has been indicated, must be the creation of an unlimited demand for bricks at $14.28 per 1000 f.o.b. yards. Let us assume, now, that we are dealing with a condition of business depression, that the cost of production of bricks is somewhat subnormal, and that the fixed

price of $14.28 per 1000 will, therefore, afford somewhat more than normal profit to brick producers. Each brickyard will, therefore, begin full production. However, the market demand for bricks is assumed to be depressed and the government has made a commitment not to *buy* bricks, but to *maintain the price* of bricks. Stocks of bricks, therefore, accumulate rapidly, their price drops, and a further reduction is required in the gold content of the dollar. This process of accumulation of stocks of bricks and of successive reductions in the gold content of the dollar must, in fact, continue until either there is developed a commercial demand for the full output of bricks, or the costs of brick production rise to a point which checks the supply. This latter situation will correspond essentially to a general rise in wages. Furthermore, construction activities and levels of wages are essentially resistant to sudden increases, with the result that an extreme reduction in the gold content of the dollar may be required before the price of bricks can be brought to 70 per dollar. This will tend to have certain repercussions on international trade and finance which will be described later. The essential point for the present is the indication here presented that the price level for a commodity or article of ordinary commercial use cannot be maintained at a fixed level unless, as in the case of the old gold standard, the government itself is prepared to buy (or sell) unlimited quantities of such commodity or article.

Before proceeding to a consideration of the conditions which would obtain under a multiple commodity standard, let us now consider the case of a second single commodity standard which might be established on the basis of an item of consumers' goods, such as shoes. Let us assume that the wholesale price of a standard pair of shoes is to be maintained at $2.50. Let us also assume that, as in the case of bricks, the volume of international trade in shoes is not of controlling importance.

In this case, again, the commitment of the government is not to buy but to maintain the price of shoes. And, as in the case of bricks, if the price tends to be maintained, stocks of shoes will accumulate and prices then fall until the demand rises, or costs of production increase.

As the next step in our analysis, let us now assume a multiple standard based on the wholesale prices of a variety of items of consumers' goods, such as shoes, plus a variety of producers' and construction items, such as bricks, and let us continue to assume that these items do not enter in important volume into international trade.

Under this new assumption, it is possible, with group price stabilization, that the price of an individual item may continue to be subnormal *provided other prices compensate by rising to supernormal levels*. In the processes of recovery from business depression, long experience has shown that increases in demand and in price levels are not the same for all groups of commodities. During some periods of revival, the demand for consumers' goods temporarily takes the lead. In other cases, the initial upturn begins with durable and capital goods. But it rarely, if ever, happens that these two groups move with even pace, in company front.

Therefore, if we assume, in a particular instance, that a lag takes place in the prices of and demand for bricks and similar items, then compensation, if it is to come at all, must arise from supernormal prices (and demand) for shoes, etc.; or, in the reverse case, we

must assume subnormal prices for shoes and supernormal prices for bricks. Under either assumption, the indications are clear that, when a condition of depression has once been brought about, any approach to a rigid stabilization of a composite wholesale price index will involve counteracting tendencies toward overproduction and price-depression. For a composite base, as for the single commodity bases previously considered, it would appear again that a fixed level of wholesale prices could be maintained only by such drastic reductions in gold content as would lead to a "flight from the dollar."

Reactions on International Trade and Exchanges

Up to this point we have not considered the effect of international trade and financial movements upon the various price changes which might be brought about by changes in the gold content of the currency. Any broad composite of wholesale prices will include the prices of many articles of regular export, such as wheat and cotton. In theory, the immediate effect of a reduction in the gold content of the dollar, by reducing its value in international exchange, should be to stimulate exports and retard imports. Prices of articles of export will rise in domestic markets, in terms of the new value of the domestic currency, and there should be at the same time a temporary increase in export movements. This stimulation, as recent experience has shown, is relatively slight, however, and is very promptly followed by foreign reactions of two sorts. In countries with managed exchanges the values of such exchanges in terms of gold tend to be depressed. On the other hand, in countries which are still maintaining gold standards, the increased pressure on the stability of such exchanges leads rather promptly to tariff reprisals, quotas, and embargoes. And a still further result is a depression in the world's markets of the gold value of the particular commodities which are exported.

As the result of this combination of reactions, the currents of international trade are not substantially changed, and the essential result is a rise of the price of exported commodities in domestic markets. Furthermore, since this rise is not quickly accompanied by a corresponding rise in costs of production, the ensuing tendency is toward a rapid increase in the production of these particular articles, which in turn will result in a decline in the corresponding domestic prices, *unless measures of production control are adopted.*

In the case of articles of regular import, such as rubber and tin, which are generally on the "free list," the change in the exchange value of the currency is reflected rather promptly in a substantial rise in domestic prices. The reactions are different, however, as to articles and commodities which are produced for domestic consumption under tariff protection. In such cases, the decline in the exchange value of the currency operates as a general increase in tariffs. To this extent, a certain few articles or commodities which have been under special pressure from foreign "dumping" may rise somewhat in price, but the shortage of demand due to the depression, in the absence of any general increase in costs of production, will prevent any substantial rise in other prices.

In addition to all the preceding, there is reason to expect a special reaction on international finance, whenever the gold content of the currency is reduced below the level required, accord-

ing to the time and circumstances, for a balance in international trade. As theory indicates and recent experience has shown, the effects of changes in the gold content of the dollar on international trade in commodities tends to be wholly temporary. However, trade in stocks and bonds will not be so quickly subject to embargoes and restrictions, with the result that any subnormal value of the domestic currency will tend, other conditions being equal, to result in heavy exports of securities, offset by gold imports. When this tendency is accentuated, as at the present time, by a lack of confidence in foreign countries, such movements may assume abnormal proportions.

The Experiences of 1933 to 1935

Having examined certain general and theoretical considerations which may govern the application of the commodity dollar to conditions of depressed price levels and business activity, it is in order to compare these indicated results with the sequence of changes in price levels and in business activity from March 6, 1933, the date of suspension of gold payments, through January 31, 1934, the date when the new gold content of the dollar was fixed, until the present time. During this period, a variety of conditions and influences have obtained, some favorable and others adverse to the expectations of those who urged the devaluation of the dollar as a means for the restoration of normal business activity.

The low point in the depression had been reached during the later months of 1932 and the early months of 1933, and thereafter, in spite of severe intermediate fluctuations, the basic trend in activities has been upward. This upward trend has, however, been influenced to such extent by the operations of the NRA, the AAA, the Securities Act, and other new legislation and regulations, as well as by large items of governmental financing and of expenditures for relief and public works, that it is wholly impossible to disentangle the separate effects, or to determine to what extent, if any, the devaluation of the dollar has contributed to or detracted from the improvement in industrial activity which has taken place from March 1, 1933, to October 1, 1935. The notable point in connection with this recovery, however, is the fact that total industrial activities, in spite of all special stimulants, have moved in the United States somewhat less than half way from their low point to what might be considered normal levels for the present date; and this degree of recovery appears to be the lowest[1] indicated for any of the great industrial countries, among which Great Britain, Sweden, and Japan already have regained their depression losses in large part or in full. To put this situation in terms which avoid reference to the always somewhat doubtful concept of "normals," the recovery in the United States has been only to the approximate level of 1931, whereas a number of the leading industrial countries have already attained or surpassed their 1929 levels of activity.

From the preceding considerations it is not possible to reach a more definite conclusion than that, among the varied influences which have operated to further and retard recovery in the United States, the devaluation of the dollar has not been potent enough as a business stimulant to hold the United States in line with the general world trend toward increased activities. For more tangible evidence, if any, as to the func-

[1] See *Bulletin #58*, National Bureau of Economic Research, November 15, 1935.

tioning of the commodity dollar in accordance with the theories of its proponents, or otherwise, we must turn to the indications which may be found in the movements of international trade and exchanges and in price levels during the period in question.

Up to the date of the suspension of gold payments, the dollar had maintained its old gold parity in international exchanges. Thereafter it moved with some irregularity and, during the latter part of the period under control of the Treasury Department, through the fixing of gold purchase prices, to 63% of its old parity on January 31, 1934, when the definite revaluation was determined at 59.06% of the old gold content. In the two months which followed, the exchange value of the dollar moved to the new gold parity where with minor variations it has since remained.

During this period of adjustments in exchange, the foreign currencies which maintained effective gold parities advanced *pro rata* with the decline in the gold value of the dollar. On the other hand, the managed currencies, of which the British pound sterling was typical and the leader, increased in substantially lower ratio. The increase in the exchange value of foreign gold currencies, in dollars, from February, 1933, to April, 1934, was approximately the 69.3% justified by the reduction in the gold content of the dollar; but the rise in the exchange value of the pound sterling, in terms of dollars, was only 50.6% during the same period, and this increase has since been followed by a declining tendency, leaving a net rise from February, 1933, to November, 1935, of only about 43%. Whether or not directly caused by the American devaluation, the accompanying decline in the gold value of the pound sterling has been somewhat more than 15%. This depression in the gold value of the pound is also a rough measure of the depression of the world gold prices of basic commodities, since the price level for such commodities has remained relatively stable in terms of the pound sterling during the past two years.

Specific price movements since March 6, 1933, have, of course, been affected by a great variety of factors other than those of currency devaluation in this country, as, for example: the world trend toward business recovery; numerous trade embargoes and restrictions, offset to some degree by treaties designed to increase trade movements; various production controls and governmental efforts to stimulate revival; and war and threats of war; as well as the great drought in the United States. Under these circumstances, it is again impossible to disentangle or measure the effects of the various influences. The most that can be done is to deal with the crude figures, without attempting to draw definite conclusions from them.

From February, 1933, to February, 1934, the Bureau of Labor Statistics index of wholesale prices of all commodities rose approximately 23%. This rise continued, thereafter, at a slower rate, with a total increase of about 35% from February, 1933, through October, 1935.

As was to be expected, the greater part of this rise was evident in commodities entering into international trade. The total rise of wheat prices over substantially the same period was 121%; of copper, 84%; of cotton, 86%; of rubber, 331%; of tin, 118%; and of sugar, 32%; while coffee prices declined 6.6%.

On the other hand, the indices for groups of items not so directly involved

in international trade moved much more slowly. Fuel and lighting rose only 0.3% during the whole period; building materials, 23%; chemicals and drugs, 12%; house furnishing goods, 11%; and miscellaneous items, 13%.

Figures of the Bureau of Labor Statistics for costs of living are regularly available only at six-month intervals. The increase from June, 1933, to December, 1933, however, was only about 4%, with a total rise of about 8% to July, 1935. Figures of the National Industrial Conference Board indicate that the corresponding rise from the low point in April, 1933, through November, 1935, was about 18%.

As a final point, the sharp rise in the dollar value of domestic exports from low levels of slightly over 100 millions of dollars per month to nearly 200 millions per month, which carried with it during the latter part of 1933 and nearly the whole of 1934 a "favorable" balance of trade approaching 40 millions of dollars per month, has been succeeded during 1935 by a substantial equality between exports and imports. With this change in commodity movements has come, during recent months, an extremely heavy movement of gold to the United States (over 300 millions in October and 200 millions in November) accompanied in the reverse direction by sales of United States securities abroad in unusual, even if not definitely determined, volume.

The variety of special influences which operated during the period from 1933 to 1935, as has already been indicated, was such as to tend to obscure the effects of the change in the gold content of the dollar. Nevertheless, the direct repercussions, through variations in international exchanges, seem to have been wholly what could have been anticipated from theory and prior experience. Furthermore, there is no evidence that the limited rise in the domestic price level has had appreciable effect on that stimulation of construction and capital goods activities which is the recognized prerequisite for any sustained increase in general activities. Employment on private construction during 1935 is still close to the low levels of 1933 and 1934, and such increase in building and capital goods activities as now appears to be under way is rather clearly traceable to accumulated wear and tear, to reëquipment to meet the requirements of gradual improvements in industrial output, and to the special stimulus given by favorable money rates for housing operations, rather than to the direct influence of rising price levels.

Having gone thus far in examining the applications of the commodity dollar to conditions of depression, it may be well to give brief consideration to one further point. The proposals made to date have assumed that the index chosen would be substantially similar to the general wholesale price index of the Bureau of Labor Statistics. However, the advocates of the commodity dollar suggest that experience must indicate the most suitable type of index to employ. It may be of interest, therefore, to consider the alternative possibilities, still in times of depression, which might exist if the chosen index represented costs of production rather than wholesale prices. In this case, we must rely mainly on general and theoretical considerations, since we have no specific experience to guide us. However, the British system of managed exchanges has some elements of comparability.

The use of an index of costs of production (roughly, average hourly wage rates) would remove many of the theo-

retical objections which arise when the commodity dollar is based upon a wholesale price index. Wholesale prices, individually and as a group, might vary freely in accordance with conditions of supply and demand. Problems of overproduction and production control would very largely, if not wholly, be eliminated. And the reduction in gold content, if made *pro rata*, would be much less than would be required in the case of a wholesale index. Furthermore, the decreased adjustment in gold content would reduce the rise in the domestic prices of export commodities and would similarly limit the collateral repercussions on international trade and finance.

In spite of the preceding differences, there would seem to be no reason to expect that the reactions of general price levels to the lesser change in gold content would vary in type from those resulting from the greater change. Wage levels and prices would still be resistant to upward change until commercial demand increased, and in practice, barring a willingness to carry the devaluation to the point required to produce a "flight from the dollar," it would seem that with either index any practical application must reduce itself essentially to a system of managed exchanges.

The Commodity Dollar as a Preventive of Depressions

We come now to a consideration of the commodity dollar in relation to the possible prevention of depressions. This requires essentially an analysis of its effect in times of supernormal prices, and presumably of full or excessive business activity. And here, again, we lack specific experience and must deal with theory and general considerations.

The proposal, in the case of inflated price levels, is that the gold content of the dollar shall be increased *pro rata* until normal price levels are restored. The immediate practical objection to this proposal is the opposition which would arise, politically and otherwise, to "killing prosperity," increasing the burden of public and private debts, reducing farm prices, etc. For these reasons, the commodity dollar and, in fact, any system of managed currency must tend to be essentially "jug handled" in practical applications; *i.e.*, to operate readily, even if slowly, for price inflation, but to be seriously handicapped in those price deflations which theory and any effective practice would equally require.

In spite of these practical objections, however, it will be of interest to examine the reactions which might occur in times of price inflation, should the gold content of the dollar be increased by regular and frequent small steps, *pro rata* with any rise in a selected price index.

For the moment, it is unimportant whether we consider an index of wholesale prices or one which approximates costs of production. The more directly controlling factor is the readiness with which business expansion may be checked, as compared with the difficulty experienced in forcing a revival when business is depressed. In addition, those foreign tariff reprisals, quotas, and embargoes which operate in the case of a reduction in the gold content of the domestic currency to prevent any sustained increase in commodity exports, would quite certainly not operate in the reverse direction to check a decline in such exports. If, therefore, the gold level of American prices should be increased, the tendency would be to check exports, increase imports, and raise the prices of American securities in terms of foreign currencies, while at the same time depressing foreign securi-

ties in terms of American dollars. The combined effect of these several factors would be to lead to substantial exports of gold from the United States and to reduce domestic business activity. Furthermore, under a widespread system of managed foreign currencies, the outward moving gold might be substantially sterilized of effect in bringing about any early counterbalancing tendency toward a rise in the gold prices of foreign commodities.

If the preceding analysis is correct, it would appear that an increase in the gold content of the dollar might operate with considerable promptness to check a rise in domestic price levels. However, it would also appear that this promptness of effect would arise primarily from indirect reactions through international trade and exchanges, rather than from direct influences on domestic activities. As to the latter, the increase in the gold content might of course be combined, automatically or otherwise, with the more conventional banking expedients of increased rediscount rates and open market sales of Federal reserve bank investments, and even with the newer device of increased reserve requirements—and the psychological effect of positive action to increase the gold content might be even more important. Nevertheless, when so combined with other factors, the operations of a commodity dollar would promise again to be substantially identical in kind and effect with those of a similar combination of banking factors and managed international exchanges.

The Need for Price and Wage Flexibility

We have now completed our preliminary analysis based on recent experience, supplemented by tested and rather elementary theory as to international trade relations and exchanges. The practical evidence is very clear that in periods of a depression a rise in wholesale prices must wait upon increased demand, or else will require supplemental production control, as in the case of wheat and cotton, if, with costs of production still relatively low, a substantial increase in domestic prices is not to be followed by a price-depressing increase in domestic output.

It seems clear, furthermore, that a commodity dollar rigidly based upon a wholesale price index would be not only practically but theoretically unworkable. Regardless of major depressions, the ordinary processes of adjustment of supply and demand will require minor variations in the relations of wholesale prices as a group to wage levels. If wholesale prices as a group should conceivably be maintained at a constant level, then the necessary adjustments must come about through (a) production control, (b) an unlimited governmental market for the commodities, or (c) constant upward and downward variations in costs of production, *i.e.*, primarily in hourly wage rates.

If we assume the first two of the preceding alternatives to be impracticable or undesirable, we must accept the third as the implied condition for any rigid stabilization of a wholesale price index. However, wage levels are, perhaps, the most resistant to quick changes of all economic factors, and it is inconceivable that they could be varied from day to day and from month to month in such manner as to maintain the necessary continuing balances between supply and demand. Such balances can be maintained in practice only through changes in wholesale prices, which must vary not only individually but as a group, in times of normal or seminormal business as well as in times of major depression.

Having progressed thus far, if our analysis is correct, we come finally to a further major consideration. The proponents of managed currencies in general, and of managed international exchanges in particular, look upon them from various angles as systems for (a) temporary stabilization following periods of currency depreciation, (b) the protection and development of international trade, or (c) the breaking of economic deadlocks arising from abnormal increases in domestic wages and other costs of production.

Of the three preceding applications of managed currencies, the first two may be disregarded for our present purposes, since their advocates, on the whole, look upon them only as temporary expedients and aim ultimately at stabilized international exchanges.

The third application is, however, of considerable practical and theoretical interest, in spite of the fact that it has, to date, been advocated only privately and in rather shamefaced fashion by certain European and American economists, and yet such advocacy has not found any substantial place in published literature.

Briefly, the concept back of this proposal is that there can be no effective defense against continuing arbitrary increases in costs of production due to legislation and the efforts of monopolistic labor unions. Such increased costs of production, it is assumed, will from time to time result in economic deadlocks, with costs in excess of the prices at which goods can be sold in international markets and with even a substantial reduction in domestic sales and consumption. And it is further assumed that such condition, unless its development is otherwise prevented, must result in a state of chronic unemployment and business stagnation until liquidated by an active depression.

In view of the preceding considerations which are based primarily upon experience rather than economic theorizing, the proponents of this particular plan propose that each deadlock, when it approaches, shall be liquidated by a reduction in the exchange or gold redemption value of the currency, of such amount as may be necessary to restore normal movements in international trade and to initiate a gradual rise in the levels of domestic prices.

In substance, therefore, these particular economists propose to counteract the evils of a false wage system by introducing the opposing evils of chronically unstable (or at least periodically shifting) international exchanges and of a currency system which will regularly penalize the life insurance holder, the savings bank depositor, and in general those thrifty persons of relatively small means who, as the figures show, are directly and indirectly the major owners of bonds and mortgages rather than of equities.

The reason for the somewhat shamefaced advocacy of this particular plan is obvious. Nevertheless, the major premise on which it is based seems sound, to the extent that there are clear-cut alternatives: either preventing, on the one hand, any long continued forced increases in wage levels at a rate more rapid than is justified by increases in productive efficiency, or accepting, on the other hand, in liquidation of the resulting economic deadlocks, a recurrence of periods of chronic unemployment and active business depression, or else a recourse to periodic devaluations of the currency. The point cannot be too often emphasized that, whatever other action may be required for increased economic stability, such stabil-

ity will be wholly impossible in the face of costs of production which, by arbitrary action or otherwise, are periodically increased beyond the level at which important volumes of commodities can be marketed. One definite (but not the only) price of economic stability, or of stability in international exchanges, seems to be a certain degree of flexibility in domestic price and wage levels.

The preceding discussion has, perhaps, been carried unduly far, but it has, nevertheless, a special bearing on the possible operations of the commodity dollar.

Certain reasons have already been advanced to show why the commodity dollar (or, in fact, any managed currency) cannot be based on the rigid maintenance of an index of wholesale prices. These reasons are supplemented in controlling fashion by the considerations presented in these later paragraphs. If wholesale prices should, by chance, be maintained at fixed money levels while wage levels and costs of production were free to rise, the economic deadlocks previously indicated would tend to be accentuated, and in such cases liquidation could come only through a period of active business depression with its resulting decline in wage levels and costs of production.

In the reverse direction, however, a managed currency or commodity dollar based on an index of costs of production would amount in effect to the acceptance of a theory of continuous currency devaluation for the prevention of these special economic deadlocks. Arbitrary increases in money wages and costs of production could go merrily on, only to be offset by continuing decreases in the gold content of the dollar. Wholesale prices and costs of living would be free to adjust themselves to production costs; and to the extent that such adjustments did not create new deadlocks or disequilibriums in international trade, and provided variations in relative wage rates in different occupations were not so serious as to create important domestic deadlocks, the process of rising wage levels and reduced gold content of the dollar might, in theory, continue indefinitely. Practically, however, it would be inconceivable that such process would not lead sooner or later to disequilibrium in international trade. For this reason, as in the recent British experience, it would in the end be necessary to relate the currency adjustments primarily to the necessities of foreign trade and to abandon to that extent the idea of maintaining an absolutely fixed monetary level of production costs. Here again, therefore, the commodity dollar would lose its special character and would tend to become, in line with our own recent partial experience, essentially identical with a system of managed exchanges.

Conclusions

We come now to our general conclusions. The difficulties and dangers of unstable international exchanges are being increasingly recognized. Sooner or later stability must be achieved. We may hope to see such stability combined at some future date with measures to prevent important long-term changes in international price levels, but stability in exchanges must come first, and stability in price levels follow when and as it can be brought about. In the meantime, and even with an ultimate greater stability in international price levels, there is a minimum degree of flexibility in domestic price and wage levels (perhaps in the scale of 10%) which must be maintained if we are to avoid periodic economic deadlocks which cannot be resolved by cur-

rency or credit manipulation, and which can be liquidated only by the drastic processes of business depression.

This situation is fully realized by many leaders in economic thought, but they have hesitated to set themselves in opposition to the current popular clamor for arbitrary wage determinations. Their obligation is, however, to tell the facts plainly and repeatedly until there is a workable clarification of the present confused public and legislative thinking on matters of wages, prices, and currency. Fortunately as to the wage problem, which is the most difficult element in this composite, there appears to be at least one tested and psychologically effective solution, which the writer has discussed in a separate article.[2]

[2] "What is a Just Wage?", *American Management Review*, September, 1935.

THE FRENCH FRANC IN 1935

BY ELEANOR LANSING DULLES

FRANCE is once more battling over the franc. The past, the present, and the future are the subject of bitter debate and wild speculation. Laval has made a strong stand against devaluation, but his position has been assailed from many angles. In fact the central stronghold of the gold standard has been seriously undermined.

In this struggle, the conflict between political and economic forces is again apparent. To some extent speculative and fundamental factors have fallen out of line with each other. Ideas as to a "necessity" of ultimate devaluation have become such a strong force that the more objective possibilities of holding on to gold are disturbed by fears of formidable proportions.

The anticipation of devaluation has caught up recent half-proved assumptions as to price disparities and has developed a static outline of new ratios almost without consideration of the many-sided change in the dynamic adjustment of international prices. It looks now as if the franc might be offered up on the altar of the purchasing power parity doctrine. This theory has been widely acknowledged to be one-sided in its emphasis on past prices and on the significance of *given* value discrepancies to *future* commerce. It now appears in less academic form as many urge that French prices are too high. It may help to deprive France of the advantages of having held to gold so far and give her in return a slender advantage in an added slice of world trade. The reshaping and forging of a money policy which inflationists have been trying to dominate will be accomplished in the fiery furnace of coming Parliamentary debate.

The Effect of Remaining on Gold

It is widely assumed by those seeking evidence on the disadvantages of deflation and the gold standard that the difficulties France has suffered recently have been greatly aggravated by clinging to gold. It is not yet certain, however, that this is the case. Many of her troubles would have been equally distressing with a cheaper franc or a managed currency. Politics would have preyed on economic endeavor as long as the world depression cut off markets and war threats excited her passion for national defense.

The complex interaction of many forces makes it difficult to give a definitive answer, but a few of the pertinent questions can be reviewed now. For instance, one aspect of the French situation, sometimes overlooked, is the indirect advantage reaped from the aid to the stability of other exchange ratios because of the gold franc. It is an open question what England and Germany would have done if France had devalued in 1931. Similarly, the dollar would have been a less determinate factor in 1933 and 1934 if France had countered the Roosevelt policy with competitive devaluation. The abandonment of the French exchange position would have removed one fixed point in a flux of values; European money markets, international calculations, and speculation regarding the rôle which gold might play would have been greatly disturbed. Confu-

sion would have increased at many points in commerce and finance. Now, at a time when national interests have been pushed into the foreground in all countries, and the inevitable interdependence of each economic system on every other is underestimated, the significance of one fixed gold price to which the pound, the dollar, the mark, and the value of gold itself have been related, is apt to be minimized.

If France seems at present to be a victim of a rigid financial policy, it is still true that she has furnished a valuable fixed point in money and credit relations which has prevented the rapid spread of financial chaos in the years 1933 to 1935. One must ask, therefore, if the resulting *de facto* stability of the pound and the dollar have meant nothing to France. The answer must take account of a substantial degree of European recovery since 1932. This would have been seriously hampered by fluctuating ratios of the dollar, the franc, and the pound. Instead of relative stability for two years, the three major currencies would have been the victims of wild speculative movements. Moreover, the operation of stabilization funds would have been difficult or impossible without a gold bloc as a point of leverage. The pound has been virtually on a gold standard by way of the franc. Foreign trade has revived somewhat on the basis of a few fairly dependable ratios. The franc stood out as one major point of reference. If the French currency had been reduced in value at the time of the gold buying policy, the change would have prolonged and accentuated the pressure for inflation in America.

The fact that the London Conference was not followed by exchange confusion comparable to that in 1924–1925 is in large measure due to the determination in a few countries to cling to gold. France may not have gained much in a positive way in this period of uncertain exchange currents, but she was saved from some of the more catastrophic changes that threatened. Moreover she was gambling for the only possible way of gaining more leadership in European money affairs. Irrespective of the final outcome, some prestige has resulted from the determined stand on gold, and authority among the smaller nations of Europe as well as the Bank for International Settlements has been enhanced. If the strain of maintaining gold had been of short duration, and if recovery on many economic fronts had come more rapidly, Paris might have exerted an influence second only to that of London and increasing substantially with the benefit of a wider financial experience. The advantages which accrued to France from keeping on a gold standard were thus of a broad general character and included such elements as the moderation of instabilities in the neighboring countries. In addition to this, Paris became a refuge for gold, and the increased reserves were a potential asset during recovery. The domestic advantage of saving the *rentier* class from another severe blow is rarely convincing to those in other countries, but is properly a major consideration in formulating a constructive financial policy.

The disadvantages of holding to the gold standard have been mainly connected with the subsequent deflation of French prices and the loss in exports and tourist trade. These are difficult to measure because they are the combined results of many interacting forces, the depression, high tariffs, high interest rates, and nationalism in every country. They will be commented on

briefly in discussing the advantages of devaluation.

Causes of Strain

Recent distress in France has been real, whatever the cause. The gold standard alone has been at times an aggravating cause and at times a help, but always a convenient scapegoat for the discontented. The French problems are never wholly economic, however, and in this case even more than usual the political elements have bulked large. The strife between groups has been accentuated recently by the lack of personal economic opportunity. Controversial issues, often relatively unimportant, have served to keep an intense bitterness alive and have flared up in serious riots on various occasions.

In addition to the traditional struggles between right and left, middle and lower classes, peasant and industrialist, there have been even more serious political issues involving relations with other countries. France has become intensely frontier-conscious. The fear of German aggression was kept at fever pitch for years, and the delicate questions with regard to alliances with Italy and England increased the instability and nervousness. Nationalism fed on these feuds, making it difficult for France to enter into constructive agreements while higher trade barriers, obstacles to the smooth operations of the money market, and unsuccessful efforts at self-sufficiency accentuated a purely defensive economic policy.

Many reasons can be given for the economic difficulties of France without blaming any large share of them upon the deflationary policy. The present discontent and business stagnation is due to three main groups of causes. The first and most significant of these is little if at all related to the gold standard. This is the budget situation. France has permitted a series of deficits and an increase in the internal debt which would bring serious trouble with any kind of monetary standard. The large expenditures for armaments are the result of the prevailing defense complex and are way out of proportion with what the nation can afford. The budget, never completely recovered from the reconstruction effort, was crowded with excessive expenditures, and made rigid by a bureaucratic system that has always made economy difficult. The internal debt is enormous when compared with those of richer countries like the United States and England. The cost of borrowing is exceedingly high and the heavy burden of the railroads increases the public loss of funds by hundreds of millions of francs. Less problems than these have brought on economic collapse on many previous occasions.

A second set of causes lies in the field of political adjustments and speculative attitudes. There is so little ground for unity on internal policy and so much dissention as to diplomacy and economics that the struggle between parties is more conspicuous than the firmness of national intentions. There is little wonder that in view of riots and upheavals in many cities, neither the foreigner nor the Frenchman is confident as to the future. The country has been squeezed between fear of Germany and a reluctance to agree with England on European policies. Italy has been a friend and enemy by turns, and the outside observer can discern no consistent determination to work out the critical problems of the moment. Diplomatically the country gained few substantial concessions and at the same time suffered the disadvantages of trying to maintain inconsistent ties with hostile nations. When these

political doubts have been strengthened by the quick shifts of financial speculation and considerable distrust as to the capacity to handle the large gold reserve to the best advantage, there is adequate explanation for the sudden and destructive capital movements.

In the third place, the decline in prices and the reduction in foreign trade worked considerable hardship on the business community. Here it is evident that the gold standard played a part, but the exact nature of its influence cannot be precisely measured. There is still sharp disagreement as to the effects first of deflation and then of devaluation in England. The French situation is equally complex. Prices declined more than in England and the United States, but not so much more that the gold standard can be blamed for a large discrepancy. Furthermore, a deliberate deflationary policy, more consistent with the French attitude toward economic affairs than that of the Anglo-Saxon countries, is certainly responsible for a fraction of this decline. As far as commerce is concerned, world trade was shrinking at approximately the same rate as French commerce; moreover the signs of an upturn were evident in France in the first six months of 1935 quite irrespective of the monetary policy. French commerce has rarely ventured far or made aggressive efforts to conquer new markets. It is natural, therefore, that in the trough of a depression there should be a relative loss as compared with more aggressive competitors. A preference for home industries and familiar trade relations has prevented a broad expansion on a lower price level. The dependence on specialties and the assumption that other nations would come to Paris to buy, left the nation powerless to extricate herself from a prolonged depression. There was a conspicuous shift of tourist traffic.

Combined with these three main reasons for the decline in production and economic unrest are many general characteristics of twentieth century France. A large and expensive bureaucracy, a narrow money market, weak government credit, "splinter" parties, and confusion in political life, meant almost inevitable trouble in financial affairs. None of these factors was directly related to the maintenance of the gold standard. No single change in financial policy would have made a substantial difference. The stimulus which would have come from an abandonment of the gold standard, once used, would have worn itself out fairly quickly and left the country in much the same position as she found herself later. The only thing that could have saved France from the difficulties which piled up in a crushing load each year during the depression would have been on the one hand a sane and constructive budget policy, and on the other hand a more rapid recovery in other nations, stimulating luxury trades and encouraging tourist traffic. These influences would have released tension and lessened mercantilism, but no such fortunate escape was accomplished.

Probability of Devaluation

Parliament assembled on November 28 in a spirit of bitter dissention. The franc pressed hard on the lower limit set by the outflow of gold, and the stream of metal shipped to the United States increased in volume. All the significant indices showed the tide running against the French exchange, and the three successive increases of the Bank of France rate on November 15, 21, and 25 indicated the temper of official opinion.

Then, after a drop in franc values, there occurred a characteristic and perhaps deceptive reversal in speculation and a relaxation of financial tension as Laval won a vote of confidence on procedure in the Chamber.

For two reasons the temporary improvement is not convincing to those who have been observing French affairs closely. The first is that the victory was a sign of a desire not to upset foreign negotiations and to avoid responsibility for the inevitable budget difficulties. The second reason for discounting the rise in the franc is that although both spot and future rates hardened, the engagements of gold for foreign shipment continued.

Along with these signs of exchange troubles, persistent rumors as to the shift in French opinion on devaluation continue to impress experts in New York and London. Prophecy varies from anticipations of prompt devaluation to confident assertions that the French will hold to their present position in spite of everything. The only useful way to discuss present probabilities is to admit the complete incalculability of the future, and then to draw up a balance sheet of pros and cons. In such a weighing of different prospects the force of the time factor, converting new individuals inside and outside the country to the arguments for devaluation, and the difficulty of winning any new adherents to the *status quo*, are always to be considered.

At the present time the current is clearly in one direction, that is, toward devaluation; but the actual outcome in financial affairs is to a considerable extent the result of political factors, and in politics there can be quick reversals of even the strongest trends. On economic grounds alone—and complete isolation of economic factors is essentially false—there would probably not be a reduction of the franc in the near future. On political grounds—and politics have gained the upper hand in most countries in recent years—a reduction of 20% to 30% seems highly probable.

These limits to probable value, indicating a four- or five-cent franc, are chosen tentatively on the basis of past experience and also in the light of many informal statements not carrying the weight of authority, but yet significant. There are also economic reasons to indicate that it would not be worth suffering the disadvantages of devaluation unless a 20% cut were made. If devaluation were less than this percentage, domestic paper prices would not register any substantial rise. Moreover, the gold profit available to the government to solve the budget problem would be inadequate. The need to create a dramatic impression of accomplishment would fall short with the public accustomed to larger changes, and the ability to hold it at the new level would be questioned almost as much as is the present value. If opinion were disconcerted by a sense of anticlimax, in case of a slight devaluation, there would be no adequate rise in *rentes* to facilitate conversion operations. Meanwhile the clamor for more stimulus to production and trade would continue.

The upper limits to a forecast are somewhat less definite but seem fairly clear to those who have already sensed the tenor of financial opinion. It is widely assumed that a 25% decline would adjust certain significant prices to international levels. More than a 30% drop would occasion a marked movement of wholesale prices and would disturb contracts, labor relations, security holdings, and fixed

obligations of all sorts. Such a percentage would wipe out profit margins at many points and lead to unhealthy speculative gains at others. Moreover, if a greater decline is permitted, the danger of retaliation in trade barriers and competitive devaluation is increased.

There have been, of course, a few cases where a larger degree of depreciation has been accomplished without catastrophe, but contributing factors have lessened the impact. In the United States, for instance, the inflationary effect that came with the depreciation of the dollar in 1933 was offset in part by strong deflationary influences. Confidence failed to give the expected stimulus to credit; commerce was at a low ebb, and import and export prices failed to stimulate commensurate changes elsewhere. Even the public failure to understand many of the implications was a stabilizing influence. No brief can be held for a particular figure, such as 25%, but the experience of other countries indicates that a large change in the value of money, say beyond 30%, greatly increases the social and financial disturbance. Moreover, the experience of France in 1926 indicates the difficulties which come when a currency is set so low that gold flows into reserves persistently and in large volumes.

The devaluation which is considered imminent by many, however great the change may be, is not unavoidable from an economic point of view. The necessity so far as it exists is mainly political and psychological. In the economic realm gains and losses are likely to balance fairly evenly for France, but the world will have lost one more point of resistance against the pressure for repudiation of obligations.

The special characteristics of the French situation which have raised tension to a high point have been mentioned briefly. Even granting these difficulties there are still two possible situations in which devaluation could be avoided. One would be a rapid rise in American prices, increasing French tourist trade and opportunities for exports, leading to a gain in the comparative position of various types of productions and services. This change would have to come quickly to help solve the immediate political dilemma. The other more difficult way of escape would be to go farther along the road already chosen and reduce costs a little more so that French products could compete on more favorable terms. These readjustments of internal values would have to be executed so skillfully as to effect a real balance between price levels and enterprises.

Even though the French nation is one of the few which really understand and value the attainment of low costs, it is very difficult to see what leadership is at hand to make possible such an ideal solution. Although there has been a strong deflationary sentiment, growing out of certain peasant instincts and based on a careful accounting of profit and loss, this cannot prevail in face of all obstacles. A memory of the losses and destruction in the inflation of 1925 is dimmed by the discouragement over the present budget situation. The defense complex, distrust of England, a failure to understand American isolation, withdrawal from European problems, and a narrow interpretation of the functions of the League of Nations, are all working to set apart France from recent currents of opinion and to intensify her internal political struggle. The very nature of her deflationary policy has led to economic introspection, and a supersensitive

awareness of conflicts of interests has set her entire social life on edge.

In recent months the give-and-take among political parties is more difficult since there are few foreign advantages to be traded. As reconciliation and compromise become constantly harder to accomplish, there is a natural tendency to seek for some dramatic act which will distract attention from petty feuds and relieve immediate tension. It is almost inevitable in such a situation that the possibilities of a swift stroke to cut loose from the present gold value would seem to offer opportunities for readjustment and to stimulate energies in new directions. It is indeed likely that such an action would tend for a

TABLE I

FOREIGN EXCHANGE AND GOLD MOVEMENTS

	Foreign Exchange Cents per Franc	*Gold Movements (in millions of dollars) on the basis of 1 ounce = $35.00*		*Bank of France (in billions of francs)*	
		Imports	*Exports*	*Gold Reserve*	*Foreign Exchange Holdings*
1933					
Jan.	3.90		63.2	82.2	4.4
Feb.	3.92		2.9	81.0	4.4
Mar.	3.94	28.2		80.4	4.4
Apr.	4.10	81.5		80.9	3.8
May	4.59	162.4		81.0	3.9
June	4.80	79.1		81.2	4.0
July	5.46	85.9		82.0	4.0
Aug.	5.37	90.8		82.2	2.7
Sept.	5.77	72.7		82.1	2.6
Oct.	5.82	44.3		81.0	2.6
Nov.	6.27		89.6	77.8	1.3
Dec.	6.12		77.2	77.1	1.2
1934					
Jan.	6.21		12.2	77.1	1.1
Feb.	6.46		175.9	74.0	1.1
Mar.	6.58		232.7	74.6	1.1
Apr.	6.62		1.4	75.8	1.1
May	6.61	30.9		77.5	1.1
June	6.60	6.4		79.5	1.2
July	6.59		2.9	80.3	1.2
Aug.	6.66		15.1	82.0	1.1
Sept.	6.67	1.0		82.3	1.0
Oct.	6.62	22.7		82.5	0.9
Nov.	6.59		65.6	82.1	1.0
Dec.	6.60	37.7		82.1	1.0
1935					
Jan.	6.58	7.8		82.0	1.0
Feb.	6.59		32.5	82.0	1.0
Mar.	6.62	19.1		82.6	1.0
Apr.	6.60	103.1		80.9	1.1
May	6.59		190.3	71.8	2.2
June	6.61		393.6	71.0	1.2
July	6.62		12.2	71.3	1.2
Aug.	6.62	56.3		71.7	1.2
Sept.	6.59	29.3		72.0	1.2
Oct.	6.59		*180.0	71.9	1.2
Nov.	6.59		*290.0	69.0	1.0

* These figures are provisional and estimates.
Source: *The Federal Reserve Bulletin.*

time at least to bring greater unity in domestic policy. It would also relieve temporarily economic pressure on prices and gold reserves, and would stimulate new types of speculation and new branches of production.

There are, it has been suggested, two economic escapes from present the disparity of price levels or complete discouragement over the tourist trade, but the need for revenue. It is essential to find eight or ten billion francs to add to the government's resources or to subtract from expenses. Only two sources seem evident in view of present money market conditions—that is, the

TABLE II

General Economic Indices

	Wholesale Prices 1913 = 100	*Industrial Production 1928 = 100*	*Unemployment in Receipt of Benefit (000's)*		*Wholesale Prices 1913 = 100*	*Industrial Production 1928 = 100*	*Unemployment in Receipt of Benefit (000's)*
1933				**1934**			
Jan.	411	70.7	316	June	379	62.6	311
Feb.	404	71.7	332	July	374	58.6	320
Mar.	390	69.7	314	Aug.	371	55.6	325
Apr.	387	68.7	310	Sept.	365	54.5	323
May	383	71.7	277	Oct.	357	55.6	384
June	403	75.8	252	Nov.	356	59.6	375
July	401	77.8	240	Dec.	344	59.6	419
Aug.	397	78.8	234				
Sept.	397	78.8	227	**1935**			
Oct.	397	77.8	233	Jan.	350	61.6	487
Nov.	403	76.8	258	Feb.	343	62.6	503
Dec.	407	75.8	313	Mar.	335	59.6	484
				Apr.	336	59.6	452
1934				May	340	63.6	423
Jan.	405	76.8	332	June	330	64.6	403
Feb.	400	76.8	351	July	322	67.7	381
Mar.	394	72.7	346	Aug.	330	66.7	381
Apr.	387	69.7	335	Sept.	333		
May	381	66.7	323	Oct.	342		

Source: *The Federal Reserve Bulletin*, except for Unemployment and Production which are taken from the *Monthly Statistical Bulletin* of the League of Nations.

difficulties, but since the troubles are to a considerable extent political in origin it is logical to point to the possibility, somewhat remote but still existent, of a sudden unpredictable political solution. A shift in diplomatic alliances or changes in the African situation might divert attention from money problems and reverse the direction of the gold flow. Such an event may occur soon, but unless it comes quickly the obvious possibility of deliberate intervention in the value of the franc should be allowed for in all plans for future business.

The most convincing and urgent sign of probable devaluation, then, is not gold reserves of the Bank, or conversion of the debt to reduce the heavy interest charges.

Many Frenchmen know that trade may benefit very little and for a comparatively short period from a cut in the franc, but they can see a direct gain for the budget. Commercial access to Germany and Italy is restricted; tariffs hamper trade with England and the United States; there are few countries which would take advantage of the price movements that follow currency changes. Devaluation now, in an age of sophisticated finance, with machinery developed to counter the falling exchange as it affects imports, is quite

different in its effects from earlier declines that were not met so quickly by tariff adjustments. It would bring a sense of relief from strain comparable to that experienced in England in 1931 and in the United States in the spring of 1933. There might even be a boom like that of July of that year in this country. There, as here, it would probably be short-lived unless stimulated from other quarters. There would certainly be some gain worth striving for if it were possible to introduce a new state of mind and to divert energy from fruitless political agitation to constructive efforts in business and trade.

Possible Advantages of Devaluation

The deserted streets of Paris and distressing riots in the last few months have shown that France is suffering from some very real difficulties, even if they are not all the outgrowth of gold standard conditions. The European political controversies have not been easy to untangle. The deflation policy has worn down the patience of shopkeepers and producers in the long trough of a depression. The tourist trade, quick to respond to money changes, more conspicuous when underscored by exchange fluctuations, has drifted elsewhere while the more permanent foreign residents have migrated to cheaper countries. The drain of gold, although largely of professional origin, has increased general nervousness.

Over against these causes of distress can be set the probable advantages from devaluation. One is the rise in paper prices, stimulating speculation, and accompanied by the reduction of gold prices for the importer of French goods. Tourist trade and the hotel business would benefit most directly. Luxury articles, such as gloves, soap, and perfume, would probably rise on the list of exports, but here again keen competition has developed at many points and no doubling or tripling of the volume could be expected. The price of imports would, of course, rise in terms of francs and the commodity index would set the peasant at variance with the industrial community.

The gold movement would, for many reasons, be toward France. It is conceivable that speculators would consider that at the new level Paris constituted a safe refuge for the precious metal. If the new rate were consistent with basic economic conditions, the reserves in the Bank of France would mount still further. Such an action might possibly be countered by gold embargoes or restrictions in trade elsewhere, but in any case steady streams of legal and illegal gold would probably flow toward Paris.

The most notable gain expected from such a move would be an improvement in the budget problem. A probable sequence of events would be a return of French capital to Paris, a reinvestment in *rentes*, a decline of the yield on government securities, and refunding operations at a lower rate of interest. Such a chain of events might make possible a saving of five or six billion francs in debt service. This saving, with the added possibility of confiscating a theoretical gold profit, would render an increase in taxation unnecessary for the present. The political temptation is obvious; alternatives are hard to see.

The alleviation of budget strain is evident but the possible price advantages are more obscure. So much argument has developed in respect to comparative price levels that it is important to recall the British and Belgian experiences, and to keep in mind the slow response of American prices to

a variety of inflation stimuli. England experienced no proportionate upward swing in paper prices in 1931, nor did industry receive a stimulus commensurate with devaluation. The Belgian and American situation can be compared with the British, and in no case has the price adjustment done exactly that which would have been expected on theoretical grounds to conform to a new gold basis.

Speculation would undoubtedly seize upon the swift movement of values following any break in the franc. The flow of funds toward France would stir business to a new activity. Essentially, however, a large part of this flow of funds would be what is known as "nervous" money. It is usually bad for the countries that receive it and weakens the countries that lose it. International funds that have not even a temporary home are an embarrassment to any money market. Paris, New York, and London have all experienced this phenomenon. They have all suffered from the sudden ebb and flow. After the distressing events of 1931 and 1933 no wise financial leadership would encourage large movements of this character. The volume of French holdings abroad would probably be reduced and a movement in concentric circles toward Paris might seem to strengthen the monetary situation, but might increase concentration on domestic enterprise to a dangerous degree. Little that is definite can be discovered about foreign holdings in France, or French holdings abroad; reliable opinion suggests that France would gain to the extent of several hundred million in the back flow from foreign investments, but would lose a certain diversity which might come with participation in enterprise outside her boundaries.

Commercial conditions might become more advantageous, but an examination of value and volume of exports over a period of ten years and of particular commodities sold abroad would indicate the existence of a slender margin of elasticity. Exports declined during the depression at about the same rate as world trade, that is, 30%, and imports about 20%, and both regained a small part of the losses in 1934. It is likely that some further improvement can be expected. A rise of 500 or 1,000 million francs in the value of exports would stimulate business activity in spite of the dampening effect of the increased cost of imports.

The strength of the gold position of the Bank of France after continuous pressure and frequent rumors of devaluation might become in the future a source of weakness. If the financial policy is such that more metal is added to these hoards, it will increase to some extent a temporary advantage but will postpone by many months the possibilities of a broad international stabilization. Efforts will undoubtedly be made in many countries to prevent a further drain of gold to France. Such efforts are never entirely successful. The United States was forced to abandon restrictions and take a more liberal gold position after 1933 in the interests of finance and commerce. Many countries will be faced with the same dilemma as that encountered by England and the United States. They will have to risk losses in gold or else face new restrictions and uncertainties in commerce. The choice will be inescapable, but the decision either way will harm and slow down business recovery.

Five Types of Devaluation

Immediate prospects indicate, not an abandonment of the gold standard,

but a change in French gold price. It is not likely that any financial maneuvers on the part of France will greatly strengthen her political bargaining power or develop her money markets to a high level of influence as compared with New York and London. French experience has not been of a character to enhance her financial power in such a crisis. There has always been a strong feeling that the 1926–1928 stabilization was selfish and destructive in its influence on international currency and credit. There is still a widely diffused sentiment that the maintenance of the gold bloc has been a narrow and restrictive policy. There is no likelihood that the new exchange leverage on other countries can be of real help to France as a financial power. The reality of certain temporary advantages cannot be questioned, but the extent to which they could be used raises serious doubts.

The bargaining power which France can derive from changing the value of the franc will depend on the choice between widely different courses. If, for instance, she elects to return to a somewhat automatic gold standard at a new level, she will draw gold and at the same time continue to stand aloof from other nations. If she aims at a higher degree of management with a restricted gold bullion standard, she may use her position to intervene at strategic moments in international financial affairs. The probability of a large stabilization fund, a natural accompaniment of a cut in the gold value of the franc, would give her an additional weapon in dealing with other countries.

At least five different courses are theoretically open to France in case of devaluation. Each has different implications and mechanisms. They cannot be rigidly classified, since they are changing and evolving, but each has notable distinguishing features. They can be described as follows:

1. Revised gold standard—Belgium
2. A managed standard—England
3. Managed dependent standard (linked with sterling)—Sweden
4. Multiple standards—Germany
5. Administrative bullion standard —United States

Each of these cases has entailed a different emphasis on exchanges, prices, and gold. In each there have been different types of freedom.

Belgium stepped down from one gold ratio to another and maintained a fairly automatic gold standard on the new level. There was comparatively little change in methods and procedures; the aim was to relieve exchange pressure, to turn over a gold profit to the Treasury, and to facilitate certain internal recovery measures.

England, although forced to go off gold by irresistible pressure in 1931, took advantage of this situation to extend the area of management and restrict the points at which the gold standard impinged on the domestic situation. Considerable attention was still focused on the external value of the pound, but a greater degree of effort than before was directed toward modifying the existing dispersion of internal prices. This policy was carried out in part by monetary measures but was further strengthened by action to increase the price of imports through tariffs. Financial efforts were successful in that they restricted the fluctuations of the pound to a narrower zone, but they were unsuccessful in their failure to cause a commensurate price rise or a rapid recovery of production.

Along with the British monetary changes came at least four other major

steps in economic reconstruction. The credit for a substantial recovery from the 1931 depression level must be shared among them. These measures were debt conversion, industrial reforms, modification of relief and insurance laws, and tariff changes. Neither "management" nor devaluation is clearly responsible for a major portion of the improvement.

Germany took an entirely different course and succeeded in isolating various internal and external price levels by means of vigorous controls. There were two or three types of standards governing as many separate price levels for domestic trade, foreign commerce, and tourists. Strict regulations set up barriers to limit the reaction of distinct price systems on each other. By sacrificing freedom she managed to maintain a narrow official exchange market on a gold basis, but actually her internal price level was divorced from world prices almost as completely as was that of Russia. Here we find an anomalous situation not apt to be copied in democratic countries, but still an interesting example of an extreme modification of the gold standard.

Sweden abandoned gold in 1931 and followed England, joining the sterling bloc, carrying further her attempts to control internal prices, and permitting the exchange rate to fluctuate with the pound in a narrow zone. The money standard of Sweden was thus in a sense indirect, and dependent. It was twice managed, in that the relation to the "managed" pound sterling was artificially maintained. The degree of conscious guidance has probably been exaggerated, but in any case it is evident that the currency was not allowed to drift on an automatic standard.

The United States is yet another case which might exert some influence on France. Her devaluation, unnecessary from the point of view of gold and capital movements, was undertaken in order to raise prices. Here, as in France, political confusion and economic uncertainty made dramatic action seem advisable to those in power. The shift was to a modified gold bullion standard with the main emphasis on domestic prices, and with the foreign exchanges controlled partly as an instrument of international bargaining. Fundamentally the program took little account of foreign exchange rates, but in practice there was some tendency to use the stabilization fund at least to prevent other nations from undertaking competitive devaluation.

There are then at least five distinct types of modifying or abandoning the gold standard in the past two years. There is a sharp contrast between the first, Belgium, the change in level without abandoning the mechanisms, the second, England, the modified use of the mechanisms with a view to more flexible and more tenable an exchange position, the third, Germany, the complete abandonment of the mechanisms and of the normal dependence on gold, and the fourth, Sweden, the attempt to moderate prices by a link with sterling exchange, and the fifth, the United States, the effort to raise prices. In all these cases the inevitable conflict between the control of prices and the exchange rates emerges clearly. England, with a longer experience at managing money and credit, has achieved a more balanced intervention than have the other countries. There is less stress and strain in the manner of administering the stabilization fund, and less disturbing sense of uncertainty in respect to the future changes in the value of money. France may choose the procedure adopted by Belgium or

that followed by the United States. She is hardly equipped to act as England and Sweden have, and will undoubtedly avoid the costly experiment of Germany.

It is probable that in France, as in Belgium, devaluation, if it comes, will take place quickly and will not be preceded or followed by a prolonged crisis in the exchanges. There is reason to think that the United States and England would have some warning, and that the other gold bloc countries would be prepared to follow France almost at once. It is likely that before setting a new level for the value of the franc some concession would be gained from England, to the effect that a *bona fide* effort by France to hold firmly to a new ratio and to refrain from competitive depreciation would be accompanied by assistance from England in maintaining steady exchange rates and the protection which her equalization fund affords. The French are almost certain to take over a "gold profit" for the Treasury and to set up a stabilization fund.

The exact course pursued may take some elements from all these cases, and the success or failure will be conditioned by many contributing factors. Past experience shows that a heavy price is paid for any monetary change, and a false step extracts a double fee from a distressed economic system.

Recent Crises

Two exchange crises have occurred in 1935—that occasioned in part by Belgian devaluation in the spring, and that brought on by internal political troubles in the autumn. Twice France has lost more than half a billion dollars in gold; twice the forward rates have soared and the discount rates have been jumped up by quick changes.

DISCOUNT RATES—BANK OF FRANCE

1935

May	24	3	July	19	3½
	27	4	Aug.	9	3
	29	6	Nov.	15	4½
June	21	5		21	5
July	5	4		25	6

The critical times are conspicuous on the chart opposite, reflected in the sharp movement of the curve of gold exports as the flow toward New York increased. The decline of gold reserves is also striking. Current foreign exchange quotations, on the other hand, do not reveal the pressure which exerted its full impact on the gold supply. For this reason the 90-day rates indicating a large discount for francs in dollars have been shaded in on the chart to indicate the turn of speculation against the franc in the recent months of strain. Wholesale prices have not been governed mainly by the gold standard difficulties, but have begun to rise slowly in concert with world prices.

In connection with these flights from the franc it must be observed that the possibilities of support from other countries are distinctly limited. Stabilization funds cannot risk large losses. English and American intervention, therefore, is limited mainly to two forms: either the purchase of gold for probable export later, or the facilitating of immediate gold exports by technical measures to make easier the physical shipment of the metal. American intervention last May is an instance of temporary help which had no lasting economic effects. It did not strengthen the franc except in so far as it steadied temporarily spot rates without changing basic conditions.

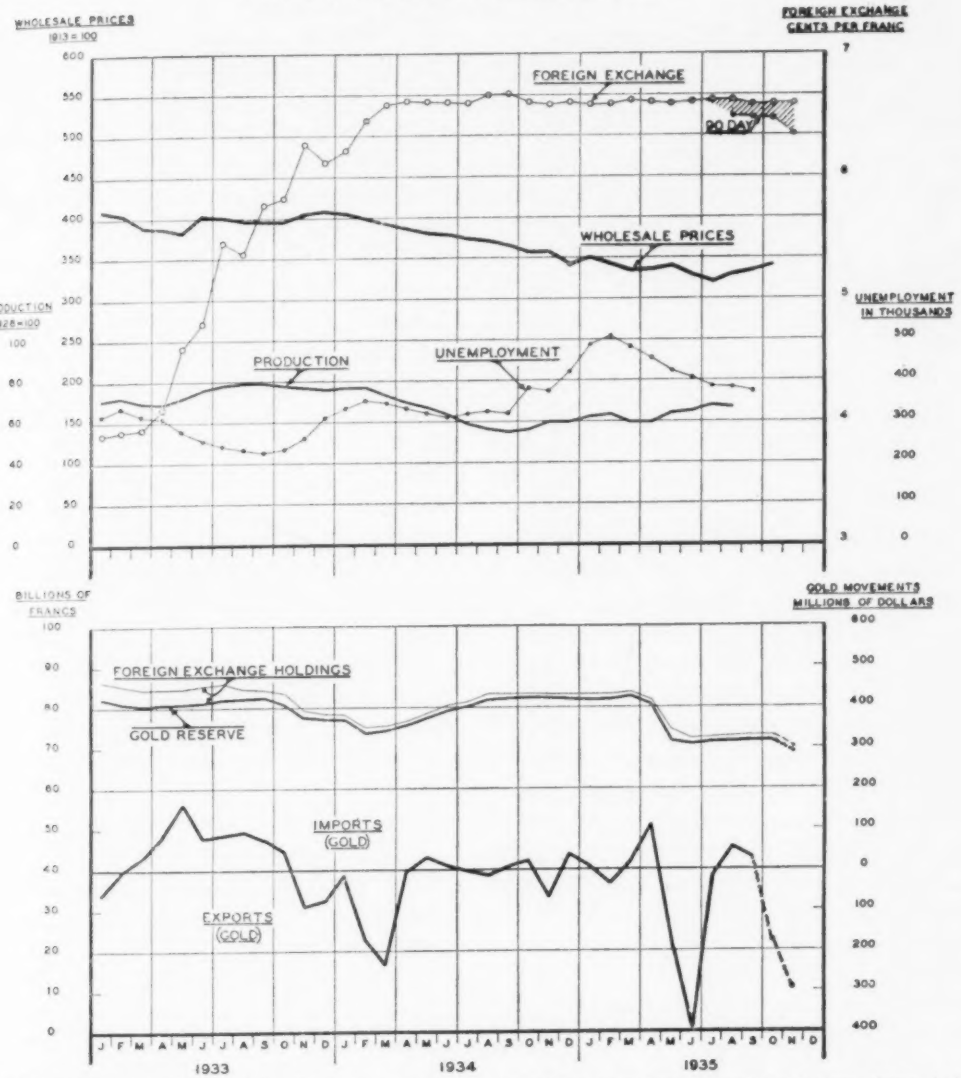
A similar attempt to aid the French now would be discounted by speculators and would probably be less constructive unless accompanied by more

far-reaching agreements between England, America, and France.

flict, and was swelled by gold actually coming from Italy.

CHART I

French Economic and Financial Indices



Note: The gold exports and imports before February, 1934, have been increased to make them comparable with those afterwards in terms of a gold price of $35.00 an ounce. Figures for October and November, 1935, are provisional or estimates.

The 90-day franc rates from *The New York Times* give the following discounts (in points): August 28—12¾; September 25—11⅛; October 28—11; November 26—24.

The second flight from the franc beginning September 9 was undoubtedly accentuated by the Ethiopian con-

The third act of the financial drama will bring new surprises, but will almost certainly end this particular gold stand-

ard episode. On the basis of gold alone the franc will not crash. Under pressure from hostile political groups and distrusting professional exchange operators it is apt to yield the ground so hard fought for four years and to fall to a lower level. The hotel keeper, the luxury producer, the inflationist, are gaining allies. Even the theoretical economists are beginning to recognize the persistent arguments for devaluation as increasingly difficult to answer. Italian gold premiums add to the difficulties of France.

The budget problem is acute. Swift action of an impressive nature must be won from a divided and uncertain Parliament. If it is devaluation, the cause of stabilization may be harmed, but the world will not be surprised. Only in a very limited sense can it be argued that currency stabilization will be aided by devaluation. To the extent that the breakdown of the gold bloc is considered inevitable it must, obviously, precede stabilization in time. In no important respect, however, will it bring the conditions essential to establishing a new and lasting system of European exchange rates. The resulting shift in price levels may help a little, but there is considerable controversy as to the nature of the present disparity and equal uncertainty as to the exact results of a change in the franc.

The date for the new order in currency relations is in all likelihood several years in the future. If the franc is held to its present gold ratio, prices will have completed an adjustment partially accomplished now. World prices are moving upward and French exports are very responsive to prosperity.

Stabilization prospects are postponed largely because of inflation possibilities in the United States. English opinion as to the future of world prices and trade is a major determining factor. There can be no decided action until British experts are confident of a favorable commercial situation. There are several unavoidable preliminaries to negotiations for permanent stabilization. These are: a greater degree of confidence in financial integrity and contracts, balanced budgets in leading countries, freer commerce, adjustment of inter-allied debts, rising prices, schemes for redistributing gold or safeguarding the gold exchange standard. French financial action is powerless in the face of these difficult requirements. England holds the key to the situation, but she cannot use it until there is a further convincing definition of American policy. Meanwhile the franc is fluctuating daily, a victim of present conflicts of opinion and of accumulated influences from past repudiation, mercantilism, and war.

LEADERSHIP WITHIN INDUSTRIAL ORGANIZATIONS

BY T. N. WHITEHEAD

THE first thing for any leader to be clear about is the character of his task. What is he to lead? For what purpose is he leading? And what is the nature and the measure of his control? Perhaps these questions sound elementary, but a little consideration will show that a failure to answer them is responsible for much of the prevalent industrial confusion.

What is the industrial executive to lead? Certainly not the several hundred or thousand employees under his nominal control, for no human being could direct intelligently such a number of separate individuals. Any executive depends on a following organized into a coherent system of integrated groups, each with its logical purpose and its accustomed activities.

A well integrated body of men is capable of being effectively led, but not a disintegrate rabble. Thus an executive has two functions to perform at one and the same time. He has to integrate his followers and he has to assist them to achieve some common purpose. In a sense these two functions are really one, for a group will integrate to an extent measured by its satisfaction in work. The present lack of adequate integration in industry suggests an examination of the ways in which labor's present occupations fail to measure up to the standard of their needs.

Obstacles to Leadership: Non-economic and Economic

Our thoughts at once turn to economic considerations, and quite clearly these are important matters; but experienced executives know how much industrial friction centers around matters other than merely economic. In this connection trade agreements are most illuminating; these so-called agreements are documents presented by one party —usually a union—for acceptance by the other party—the employers. Almost everything under the sun is the subject matter of some trade agreement or other, even down to the provision of adequate clocks in workshops. Presumably every matter regulated by a trade agreement has seemed of importance to someone, and the scope of these matters is so bewilderingly wide that at first sight nothing can be made of it.

One thing clearly emerges from a study of trade agreements; the worker is not confining his attention to strictly economic considerations, although he is thinking of these, too. The worker is thinking of his entire range of activities and interests, and evidently these matters do not seem to him to be adequately guarded by the ordinary industrial procedures. Of course, any one trade agreement will only mention a very few items, apparently chosen at random. One agreement will specialize on clocks and conditions of dismissal, whilst another will minutely regulate the conditions under which the worker may be paid by check, a third will specify the apportionment of types of work as between grades of workers, and a fourth will determine at what place in a worker's daily travel he shall be deemed to be "on the job." And so on; the list is endless.

If they did nothing else, trade agreements would remind us that firms are associations of men and women, organ-

ized for an economic purpose but necessarily involving, either directly or indirectly, the whole range of its workers' interests, hopes, intentions, and acts. There is no escape for industry from a full participation in the life of the community. This is a hackneyed statement, for everyone realizes that industry penetrates into the homes of a civilized community. What is not so well understood is that the community has entered into the workshops and offices of industry. In other words, industry is peopled with men and women bringing with them their entire stock of interests and sentiments, and above all their social sentiments, which are among the oldest and deepest sentiments they possess.

This is the real starting point of our problem. For industrial relations involve social sentiments in the same degree as do relations in any other sphere of activity; and leadership in industry cannot be effective unless it takes full account of those social sentiments which give to industrial groups their capacity for integration.

Management and Group Integration

At one time it would have been very difficult to discuss the practical functioning of associations or groups for lack of systematic research in this direction; but more recently a number of careful studies of actual groups have been made. These reach all the way from primitive tribes, trading and manufacturing bodies, political groups, national groups, city groups, down to small industrial groups within a single workshop; and certain generalizations seem to apply to them all.

Every successful enduring group of whatever kind is found to be performing two related services for its members. In the first place, the group is organized for some explicit purpose, and this purpose is broadly economic in character. This is the avowed object of every enduring group, and this is the function of leadership that is invariably recognized.

But human interests and needs are also social. It is the economic motive *within a social setting* that is of importance to human beings. Very little expenditure but is heavily conditioned by the habits, customs, and sentiments of those around us; the very range of our furniture, the food we eat, the arrangement of our days is the outcome of social conditioning and sentiment. So no group can remain integrated for long unless it is so led as to satisfy its members' social sentiments. That is to say, the group must find in its work activities some satisfaction based on interhuman relationship.

Moreover, it is repeatedly found that the integration of a group depends primarily on habitual actions performed in common. Integrating sentiment is built up just in so far as these habitual social acts are encouraged and maintained; while any blow to accustomed collaboration proves equally a blow at integrating social sentiment.

It is important to be clear as to exactly what constitutes a social act. This may take the form of a conversation or a dinner party, but these are not the types of social acts that integrate working groups. What are referred to in an industrial situation are the routine actions performed by one man to fit in with the actions of some other member of the group. When a worker bares the end of an insulated wire to enable his neighbor to solder that wire to a terminal, that is a social act. Socialization of activity occurs when it is guided or modified by the activities of others. In

this sense very little activity is entirely devoid of a social element.

Endless examples might be quoted to illustrate the connection between social routine and group integration. For investigation shows that social behavior is exhibited at levels far below explicit attention or knowledge, and on these levels of behavior are built up sentiments supporting group integration.

This constitutes a first generalization with respect to group behavior: *Group integration depends on routine relations between people developed over a period of time.*[1]

Conversely, the interruption of routine relations is the surest method of causing disintegration within a group. The social sentiments, friendships, loyalties, and work interests, are cut off from their roots; for no sentiment is wholly without relation to action, although the connection is often hidden from easy view. Moreover, stable social sentiments are of comparatively slow growth for the most part, and when broken down not only do they rebuild slowly, but their decay is apt to be associated with antisocial or disruptive sentiments.

This leads to a second generalization, for sentiments once aroused have a life of their own and they resist violent extinction.

A group will quite unconsciously resist any threat to its own cohesion. The Western Electric Company, in their Hawthorne researches, have contributed to our knowledge on this matter. A study was made of a group of skilled workers, men, who were behaving in such a manner as to isolate themselves from the apparent vagaries of managerial control. Management, for no doubt adequate logical reasons, is prone to rearrange the working conditions of its workers with scant regard for the social routines and sentiments it is unwittingly breaking. In consequence, industrial groups develop a series of routines designed to nullify the effects of managerial activity. These routines are not logically evolved, and for the most part are explained by the workers on entirely different grounds; nonetheless they are only found in groups fearful for their own survival. I refer to such matters as eliminating fluctuation of output, which is closely related to restriction of output; a failure in passing information up the supervisory line; and generally a lack of coöperation in the economic purposes of management.

The Western Electric researches are very relevant to this problem, but the same behavior has been observed in studies of other industrial groups. Mathewson in his investigations into "Restriction of Output among Unorganized Workers" draws a similar picture.

Clearly management's concern should be to assist group integration among its workers, and to be in some sense included within that group. At all costs the management must avoid action which may seem to threaten the habitual routines of a group, for in that case the group will react by putting itself beyond the possibility of intelligent leadership. Anyone who has watched the fate of so many logically adequate motivation devices will know exactly what happens when a group resists its appointed leaders.

So the second generalization amounts to this: *A group will resist any outside threat to its own integrity by withdrawing into a self-made shell, and so ceasing to collaborate effectively with the larger so-*

[1] This matter is discussed at greater length in a previous article, "Human Relations within Industrial Groups," XIV HARVARD BUSINESS REVIEW 1, Autumn, 1935.

ciety around it. This is group integration at a low level; it maintains some sort of internal integrity at the cost of its external integration. In particular, if a group feels itself to be threatened by the activities of management, the group will, so far as is possible, exclude the purposes of management from the scope of its intelligent consideration, and it will blindly fight every effort of leadership from that quarter.

There are a number of ways in which management could do something to avoid threatening the integrity of the groups within their control. For instance, management might adopt a wholehearted belief in the value of social integration. For, curious to relate, in spite of endless talk about the value of "*esprit de corps*," "morale," and the like, many executives become visibly uneasy when this sentiment begins to build up in the only way possible to it. What is asked of the worker is a vivid loyalty to some high abstraction variously referred to as "Company Policy," "The Firm," or even "The Principles for Which We Stand."

But loyalty is a social sentiment and it is built on routine collaboration, starting with quite small groups within the structure, and gradually spreading outwards as these groups begin to integrate among themselves. The progress of loyalty is from small to larger associations; this is the story of American Federalization; it represents the historical growth of most large companies, and it is the story of integration in any wide association of human beings.

What is feared of integration within a small group is that the group may organize itself in opposition to the larger whole—and this it will certainly do if its existence be threatened; but equally, a protected group will endeavor to satisfy its wider interests by collaborating with the organization of which it is a logical part.

Talking is usually discouraged among workers, and undoubtedly when over indulged such behavior leads to inefficient work. On the other hand, there is evidence to show that, in some circumstances at least, permission to talk not only makes it more possible for a group to integrate itself, but the very fact of permission is visible evidence of management's attitude toward group integration. Western Electric experience suggests that, in so far as the group is collaborating freely with the management, the group itself will control talking and any other activity when the work shows signs of suffering thereby. Again, rest pauses have not only a direct effect on work habits but also facilitate interhuman contacts. In such ways management not only encourages group integration, but also captures the loyalty of the group by a demonstration of interest in its well-being.

However, it is not always possible in a progressive firm to avoid breaking down groups as a result of technological advance or for other reasons; and in any firm draughtsmen can be seen with plans of available floor space working out some improved arrangement of machine tools or of office desks. But every tool or desk presupposes a worker, and it is relevant to suggest that not only is there a better and a worse spatial arrangement for the stage property, there are also better and worse dispositions of the actors themselves. Yet it would be very exceptional to see a planning department spending its time in devising arrangements to secure continuity of existing groups. I have never witnessed this sort of planning, and yet it would be well worth the trouble.

Leadership to Meet Necessary Change

Probably we are all ready to admit that the maintenance of integrated industrial groups lies somewhere at the root of successful employer-employee relations, but the main problem has yet to be faced. It is possible to go a long way in the direction of encouraging group integration, both inside the group, and as between groups; but only to a very limited, though important, extent is it possible to prevent frequent changes in the social routines of each individual or small group. Coöperative sentiments are slow to build and easily broken, and if their existence in a firm were to depend on the rigid maintenance of the *status quo*, then the outlook for industrial leadership would be black indeed.

And so the real problem for industry amounts to this. If we assume every assistance on the part of management for the building and guarding of intra- and inter-group integration, under what conditions will the workers accord their management the right to lead them through the continuously changing path of economic efficiency?

This is after all the common need of all ranks from bench hand to president; not one of these men is working for the pure joy of the activity. They all wish for a successful economic issue to their labors, but they wish for economic efficiency *as an essential aspect of their social framework*. The bulk of these men's lives is spent within the walls of the factory. If in the process of securing economic efficiency the social framework is destroyed, then the situation becomes intolerable; and equally, if in securing a full measure of interhuman activity, the economic purposes are neglected, again the situation collapses. Leadership is required to promote both the economic and the interhuman aspects of activity. Each depends for its value upon the other, and together they constitute social living.

If the history of any group with a record of successful and enduring integration be carefully examined, two things will be noticed. First, the group is at its best during those periods in which the leadership is vigorous. And, secondly, when the group is being effectively led its character and functions are undergoing marked change.

Of course, we must not be misled by names and formal descriptions. One of the unconscious devices by which a changing organization preserves its continuity is in the adoption of a formal description which will cover the extending range of its activity. For instance, consider the Supreme Court of the United States. This group has a long and honorable history, and its formal description would cover that record from the beginning to the present day. But every school boy knows that the Supreme Court began with a strictly legal objective, the last court of appeal in a hierarchy of essentially similar institutions, and it has emerged as the guardian and interpreter of its country's governing activities—a complete and far-reaching evolution of function. One of the finest periods of the life of the Supreme Court took place under the leadership of Mr. Justice Marshall, a vigorous leader during a period of great change. Another successful institution has been the British Parliament during the nineteenth century, and here again its most effective activities have been during periods of strong leadership and marked change.

Any group or institution, from religious bodies to industrial companies, will show the same relation between effectiveness, leadership, and change.

The outstanding period of American Trades Unionism, under the vigorous leadership of Samuel Gompers, was not marked by a pedantic maintenance of the *status quo* in union activity. Precisely the same thing applies to industry; firms disintegrate as soon as they cease to evolve. Finally, in small industrial groups, involving only a handful of workers, their periods of effective integration are found to depend on change guided by competent leaders.

After all, this is the barest common sense; a ceaseless struggle to maintain an unvarying situation would be a dreary prospect. People, in so far as they are happy and active, hope for a positive outcome to their labors in the form of acceptable change.

And this is a third generalization. *Change to be acceptable to a group must come from within, and must appear as the visible need of its present activities.* Change imposed from without is a disaster, comparable to an earthquake, breaking rather than assisting integrated evolution. So management in industry can lead its groups to just that extent to which it is itself a member of those groups, and it can lead no further; anything beyond that will be resisted as compulsive interruption to social living.

Management in the past has made many and sincere attempts to capture the loyalty of its industrial groups; often the attempt has been disappointing, and even when successful the leaders have never succeeded in stating quite explicitly the basis of their achievement.

It is the business of the leaders to secure not only the social but also the technical, logical procedures on which the activity of their groups depends. At this level the leaders are rightly considering activity in terms of economic abstraction. Their mistake lies in supposing that the actual daily integration of a group of workers can be made to depend on a logical proposition, rather than on habitual routines sensibly adapting themselves to meet a visible situation.

Any executive from his own experience can cite instances where some needed change in routine has been patiently and clearly explained to a group, only to find in the end that the group has ruined its chances by resisting the change. At first the group seems to acquiesce, impressed by the logic, but soon resentment or some similar sentiment indicates a reversal of attitude. Neither management nor the workers themselves can usually explain what has happened. The fact is, nothing in the workers' daily experience has indicated the need for change; it presents itself not as a sensible adaptation to a visible situation, but as a blow from management wrapped up in a tissue of unanswerable logic. The better the logic the more irritating is the blow.

At times of crisis nations accept a leadership which would ordinarily provoke the most violent opposition. Witness, for example, the actions of Mr. Roosevelt's Administration during the banking crisis of 1933, or the loss of personal liberty cheerfully accepted by belligerent nations during the World War. But then the crisis was visible to every individual, and the remedial changes inaugurated by their leaders only expressed the sound sense of the society. Yet another example can be seen in the millions of employees who were laid off by management during the late depression. On the whole this action was accepted by employees because their experience indicated the necessity. This was no question of abstract logic but of visible circumstance.

Any such action on the part of management in normal times would inevitably lead to a social revolution.

Men actually welcome a leader who will organize them for the purpose of adequately meeting visible situations, for this involves the satisfaction of a need: integrated social living, and its effective continuance. But no one enjoys a disturbance to his social living if the need is not apparent in terms of his life, even though supported by the best of arguments. So it is quite useless for industrial leaders to attempt to sell their policies to labor on the basis of reasoned statement alone, even though the need for those policies was originally detected by logical thinking. What is required is that a firm be so organized that the need for change is visible to the relevant groups in terms of their own daily activities, and this is not so difficult of achievement as may appear at first sight.

Naturally it is not suggested that no change should ever take place without the whole background being familiar to those involved. If this policy were pushed to its logical limit, then practically evolution would come to an end. We all submit to a certain amount of direction the object of which is not clearly apparent to us. But in industrial situations the worker is subjected to an unusual amount of unintelligent restriction—unintelligent in the sense that *his* intelligence can make nothing of it in terms of familiar fact; equally his opportunities for experiencing intelligible leadership are far too few.

Management and the Shop Foreman

The object of management should be to redress this balance; for in so far as the worker is habitually being led to achieve adjustments, which his own sense requires, to that extent will he have confidence in his leaders, and he will give management the benefit of the doubt in those changes for which daily life cannot possibly have prepared him. Let us consider the possibilities of such an organization of industry a little more closely, for we have reached the very core of our problem. One line of approach is through the junior supervisor. Management, to an employee in a large establishment, is a vague abstraction somehow connected with well furnished offices. The worker hardly knows his managers as real human beings; even if he is on nodding terms with his president they have no routine activities in common.

The true representative of management for the employee is the junior supervisor, or foreman as he is sometimes called. This is the only end of management with which the worker has real contact, in the sense of daily interpersonal work relations. So it falls to the foreman to make visibly intelligent the policies of management to labor, and also to make equally visible to management the situation at the workers' level. If the foreman fails in this task, the organization will fall into two unconnected groups, one of which will be issuing unintelligible orders to the other.

Thus, in many ways the foreman has the most critical job in the whole organization. Equally in the nature of things his is the least experienced and least tested of all the ranks of management. And yet in spite of this the foreman is probably required to display a wider range of personal capacities than any other rank. Here is a description of the foreman's duties. "The all-round foreman is still, especially in smaller plants, required to assume the most multifarious tasks. He has been expected to fix rates, fix costs, supervise machine in-

stallation and repair, hire workers, keep production records, inspect work, train new employees, advise on progress changes, and secure the required output. He would indeed be a paragon who in this confusion of duties could be solicitous about the niceties of human relations. Inevitably in the past there has been overwork, on the one hand, and neglect of important functions, on the other."[2] In larger organizations some of these functions are taken over by specialized departments, although as the authors point out there has been a swing away from overdepartmentalization of the foreman's functions. In any case the foreman remains a "jack of all trades" rather than a master of one of them.

Nevertheless the all-round foreman has one great merit, assuming that he could perform his functions; he integrates the multifarious factors of his workers' activities at the working level, that is, within full sight of his group. His problems present themselves in terms of his group around him, and his solutions are drawn from the texture of his group's daily life. Unfortunately, it is nearly hopeless to expect the foreman to evolve suitable adjustments unless his duties are simplified.

The departmentalization of the junior supervisory function does effect such a simplification, but at the expense of removing the task of integration, and therefore of initiation, from the workers' level. Under such a system this takes place in the offices of the higher executives, and the outcome makes its first appearance on the floor in the form of executive orders. So, of these two systems, the first secures some measure of initiation at the workers' level, but places an intolerable burden on the foreman; the second relieves the foreman, but at the expense of removing all initiative from the level of the working groups.

It is a well-known fact among industrialists that the lines of authority in an organization are mainly vertical, from the worker to the president, but the lines of collaboration tend to run horizontally between officials of approximately level rank. This second line of collaboration has usually no recognition in the formal set-up of the company, it is an unofficial activity held in check by the formal organization built on more or less vertical lines. These two organizing principles correspond to a fundamental difference in the place at which initiative is exercised. Horizontal lines of collaboration, in so far as they are effective, result in daily adjustments being elaborated at the level at which the problems arise. Thus initiative remains in the hands of those whose daily activities have shown the need. On the other hand, when the process of collaboration is forced up the lines of formal authority, then integration and initiative take place above and are brought down to the relevant level in the form of orders.

The all-round foreman is an instance of horizontal collaboration, only, as in the case of certain foreign dictators, he happens to contain all the collaborators within his own person—he collaborates with himself in his various capacities; there lies his weakness, and implicitly he seems to know it. For anyone with a first-hand experience of factory life will recognize the many unofficial ways in which a foreman creates a small group of collaborators officially denied to him.

John, an elderly mechanic, shows some aptitude for training novices and he, unrecognized by the formal organi-

[2] Tead, Ordway and Metcalf, H. C., *Personnel Administration*. Second edition. New York: McGraw-Hill Book Company, Inc., 1926, p. 169.

zation, is the *de facto* trainer for the shop. Tom is quick at figures and he looks after the foreman's paperwork. Someone else can fix the machines and keep them working; and so on. These men are the foreman's unofficial collaborators, and they represent him in his many capacities. Without such a shadow staff the position of the foreman would be quite hopeless; but he very reluctantly admits to such assistance, for it is not recognized and is often not tolerated by the senior executives.

Thus the foreman, on his own initiative and in concert with his group, has elaborated a modification to meet a visible situation; visible, that is, to the working group. But management, so far from assisting this display of initiative at the relevant level, is usually blankly ignorant of it and tends to discourage what it sees. And yet a development on these lines is worthy of considerable thought, for it does make possible a modification within a group to meet the circumstances that arise there, and it simultaneously relieves the foreman of an impossible combination of tasks. The Western Electric Company is engaged in a careful survey of the extent to which such unofficial organizations have taken place, and the tentative findings are exceedingly interesting. They illustrate the continual tendency for adjustments to take place at the level at which the need becomes evident, and the degree in which a formal organization can easily act as a check on such natural growth. Thus, management unwittingly holds back its employees from effecting technical changes to meet needs visible to them. And this brings us to our last generalization. *No society or organization is averse to change provided the initiative for that change takes place at the relevant level—at that level where the daily activities have shown the need. Under those conditions change will present itself not as an interruption, but as the natural flow of social living.*

Questions of Company Policy

Large questions of company policy do not usually disclose themselves in the daily activities of the workers. Such questions are visible only to the senior executives, and all ranks are willing to leave the initiative there. But most, not all, of the changes introduced by management into a working group concern small matters which have arisen from within that group. The group is failing on delivery, has high operating costs, has neglected quality, or is careless of company property; circumstances like these give rise to most of the small detailed changes which are resisted so bitterly when initiated in the offices of the executives. And yet experiments and exceptional organizations here and there have shown that it would not be impossible to reorganize working groups, so as to enable them to supply much of the integration and initiative needed to cure their own ills. To the extent to which this is accomplished, management would represent itself as a body assisting their groups in working out their own visible problems, rather than as disturbers of social living. Management would be called upon to effect an integration as between small groups.

This is not a scheme for employees' representation, though that has its place; it amounts to suggesting that initiative should not be too exclusively concentrated at the top, but should be encouraged at every level in those matters relevant to that level. More-

over, the form of the encouragement should be that of evolving an organization which will enable each level to obtain a perspective of its own problems and then to handle them effectively.

One last point arises in this connection. Any large and enduring organization must possess a formal structure and forms of procedure. In the case of a nation this comprises its constitution and its laws. A commercial company functions under the relevant laws supplemented by its own constitution and regulations. These latter require continual modification to meet changing conditions; but where the formal structure attempts to force new procedures not arising from the situation visible to those affected, or worse, hampers attempts at natural growth, then poor integration is almost bound to result. An example in point is the habitual failure of the formal structure to accommodate itself to the existing horizontal collaboration. It should be the object of company regulation to give form and assistance to such a growth, and to insure its orderly evolution.

Conclusion

A study of groups and human organizations has led to the formulation of four generalizations.

1. Group integration depends on routine relations among people developed over a period of time.

2. A group will resist any outside threat to its own integrity by withdrawing into a self-made shell, and so ceasing to collaborate effectively with the larger society around it.

3. Change to be acceptable to a group must come from within, and must appear as the visible need of its present activities.

4. No society or large organization is averse to change provided the initiative for that change takes place at the relevant level—at that level where the daily activities have shown the need. Under these conditions change will present itself not as an interruption, but as the natural flow of social living.

These findings go some way toward determining a desirable attitude for management in the handling of its working force. Thus it follows that all such devices as profit sharing and the like, whether desirable or not, cannot in themselves create integrated employer-employee relations. To suppose otherwise would be to commit the old mistake of thinking that human relations rest on logical concepts, rather than on daily social routines directed toward a logical end.

Again the Russian system of control by Soviet Councils is obviously beside the point. It will not help to free the employee to have him breaking into the president's office, for the proper activities of senior management do not declare themselves at the worker's bench. In fact at this very time the Russian factory worker is rebelling against a speeding of production nominally inaugurated by himself. A Russian factory makes provision for the interruption of the president by the worker, but it does not provide for the latter to exercise initiative at his own level.

And that indicates our main conclusion. A contented, integrated organization accepts progressive leadership, because each group exercises some initiative in those matters which concern its own activities and arise out of them. It is quite untrue to suppose that under such a system most individuals feel constrained because some of their circum-

stances are clearly beyond their own effective control. No sensible citizen wishes to erupt spasmodically into the councils of the Department of State at Washington, but he does wish for a voice in those matters which arise directly from his own activity.

Finally we should do well to remember that by far the largest part of the changes promoted by management and resisted by employees do not arise from major decisions of policy intelligible only to the former, but from petty considerations springing directly from the daily activities of the employees themselves. In so far as working groups are organized to handle their own affairs, to that extent will management find itself within those groups, and so welcomed as their natural leaders in matters outside the group's control.

SUGAR, A CASE STUDY OF THE RELATIONSHIP OF GOVERNMENT AND BUSINESS[1]

BY JOHN E. DALTON

FOLLOWING the inauguration of the present Administration in 1932, there has been—in terms of our political, social, and constitutional history—an unprecedented expansion in the control exercised by the Federal Government over the economic and business affairs of the people. The legislative acts which provided for this dramatic entrance of Federal power into the realm of business were passed during a period of national distress, and those acts were accepted by the business community with some fear but without great debate. Now, however, active and impassioned discussion is heard on the wisdom, necessity, and propriety of all of these acts.

Overwhelmingly, business men appear to be of the opinion that the broad extension of Federal powers in the matters of business activity does violence to the principle that government should stay within its "natural" sphere of activity and should not enter into activities which are foreign to its purpose. The bill of criticism listed against the extension of governmental powers is not particularized but stated in general terms. However, the major reaction appears to be that the government cannot plan for nor direct the activities of industry with the same degree of success as business men. It is pointed out that the government is made up of men untrained in business, and why, it is queried, should these men be substituted for trained leaders in the work of carrying on industry? It is contended that the government personnel has neither the ability to formulate an industrial plan nor the capacity to follow it through. The difficulties of forecasting economic events, the inevitability of the application of political pressure, and the tangle of governmental red tape are all listed to prove that industrial planning under the direction of the government is bound to fail. It is further stated that the extension of the governmental arm into the realm of industrial direction is not only bound to fail, but that it will retard normal recovery inasmuch as it unsettles the confidence of business men in planning for the future. Very little support can be found in business circles for the idea that the central government can accomplish positive good in the direction of economic activity.

Even though we may be reasonably certain that business leadership is extremely critical of any attempt on the part of the government to direct industry, the fact remains that a substantial part of our economic life is, in some degree, so directed. At the present time, this control is exercised primarily over the production and distribution of our major agricultural commodities, such direction being given through the terms of the Agricultural Adjustment Act. By the terms of the Guffey Coal Act, it was anticipated that a large measure of control will be exercised over the production and distribution of coal.

It is possible that the extension of Federal powers over matters economic

[1] Editor's note: This paper was written (November, 1935) before the Supreme Court Decision was rendered in the Hoosac Mills case involving the constitutionality of the Agricultural Adjustment Act.

may be seriously curtailed by a fundamental shift in public policy as expressed by Congress, or by a nullification of these activities by decisions of the Supreme Court. Whether or not such a possible termination of this new trend in American life would be permanent is a question which cannot be answered at this time. However, a superficial inquiry into the relationship of central governments to business throughout the world leads one to believe that a complete reversal of this trend is unlikely. Therefore, it appears necessary and wise for businessmen to analyze carefully any evidence which might throw light upon the opinions they hold in this regard.

There has not been sufficient experience gained to disclose the final answer as to the natural and proper rôle of government in industry. The general lack of experience, however, does not preclude an examination being made of specific results obtained in certain cases. One of the best cases afforded for study of the government as a planner and director of business is found in the development and administration of the Sugar Act.[2] By the terms of this act, the Secretary of Agriculture is given broad powers to control and direct (a) the production of sugar beets and sugar cane in the continental United States, in the Territory of Hawaii, in Porto Rico and the Philippine Islands; (b) the processing of raw sugar (or refined beet sugar) from such production; (c) the marketing of such raw sugar (or beet sugar) into the United States by processors, importers, and exporters; (d) the refining of such raw sugar by the refiners on the Atlantic and Pacific seaboard; and (e) the ultimate marketing and distribution of such refined sugar. The Sugar Act represents an attempt to direct the developments of an industry having a yearly product value of over $500,000,000, and it consequently affects directly the business leadership in this industry and the well-being of thousands of agricultural producers and industrial workers.

It is the purpose of this paper to examine the origin of this legislation, to consider the attitude of business men towards its creation, to outline the difficulties which were found in its development, and to analyze the major economic and political factors which were favorable and unfavorable to its administration. This is done in the belief that the most effective method of studying the necessarily complicated problem of government in business is through an examination by the case method of the facts as they have been disclosed. It is through specific inquiry rather than through *a priori* judgment that some progress may be made in this direction.

Maladjustments in World Markets

The production, distribution, consumption, and pricing of sugar occurs throughout the world. Consequently it is impossible to present the nature of the economic problems which confronted the domestic sugar industry in 1933 (the year of the development of the act) without considering the international sugar situation at that time. In brief, the facts are as follows:[3]

(1) During the World War, the European production of beet sugar fell drastically under the double impact of the

[2] Jones-Costigan Sugar Act (Public—No. 213—73rd Congress), to include sugar beets and sugar cane as basic agricultural commodities under the Agricultural Adjustment Act, and for other purposes; approved May 9, 1934.

[3] For a detailed picture of these developments, the reader is referred to *Sugar*, the memorandum prepared for the Economic Committee of the League of Nations by Dr. H. C. Prinsen Geerligs and others, Geneva, 1929; *Considerations on the Present Evolution of*

necessity for the production in these countries of indispensable foodstuffs, such as cereals, and a shortage in agricultural labor. From the prewar highest crop of over 9,200,000 long tons in 1912, European production decreased to a record low crop of approximately 2,900,000 tons in 1919.

(2) In order partially to offset the reductions in beet sugar resulting from the War and to take advantage of the high prices prevailing in the world markets for this basic material, there was an increase in the world production of cane sugar from approximately 10,404,000 tons in 1912 to over 13,696,000 tons in 1919. This increase of approximately 3,000,000 tons was supplied in large measure (44%) by the rapid increase in Cuba. As a consequence Cuba became war-rich.

(3) With the declaration of peace and the restoration of more normal economic conditions in Europe, there was a rebirth in the continental beet sugar industry. A steady increase took place after the year 1919, until by the year 1929, with a crop of over 9,214,000 tons, Europe was producing beet sugar in a volume generally equal to that prevailing before the War. In sugar, as in wheat, this increased production meant that the European market was becoming drastically narrowed (by means of government tariffs and subsidies) as an outlet for the raw materials of low-cost, oversea areas.

(4) This recovery of beet production in Europe did not stop, however, the increase in the world production of cane sugar that was accelerated by the shortage during the War. By 1929 the trend of the increased production of cane sugar had reached the all-time high record of over 20,416,000 tons.

(5) By the year 1929, then, the production of beet and cane sugar stood at a record high level.[4] This increase in the world production of all sugar was excessive in terms of the world demand, even though world consumption for sugar had increased by approximately 4½% annually.[5] The excess of production over consumption found expression in an increase in world stocks of sugar which in the year 1929 were 213% of the base years, 1923–1925. This enhancement in world stocks, largely accumulated in Cuba and Java, pushed down the world price of sugar, and for the year 1929 that price was approximately one-half (49.7%) of the 1923–1925 average. As in the case of wheat, depression in sugar was well under way throughout the world before the great depression of 1929.

(6) In face of the maladjustment of world production, an attempt was made to limit production through a restriction program under the Chadbourne Plan in 1931. This plan for the adjustment of part of the world supplies of sugar was of limited value in face of the continued maladjustment in production which occurred in those areas outside of the Chadbourne agreement.[6]

Agricultural Protectionism, Economic Committee, League of Nations, May, 1935; and to the excellent chapter on sugar found in *World Trade Barriers in Relation to American Agriculture*, Senate Document, No. 70, 73rd Congress, first session, chap. XIV, p. 226.

[4] The output in 1929 of over 30,672,000 tons has not, with the exception of the year 1930, been reached since that date.

[5] As estimated by Dr. Gustave Mikusch in *Sugar*, memorandum prepared for the Economic Committee of the League of Nations, p. 48.

[6] The following table shows at a glance the relative increase in the production of sugar in the "controlled" and "uncontrolled" areas in the world, 1929–1930 crop = 100%.

	1929–1930	*1933–1934*
World	100	88
Controlled by agreement (Primarily Cuba, Java, and Czechoslovakia)	100	49
Uncontrolled	100	123

Compiled from data in *World Economic Survey*, Fourth Year, 1934–1935, League of Nations, 1935, p. 97.

With a decrease in the world price to 60 cents per 100 pounds in the summer of 1932, 15% of the 1923–1925 level, central governments throughout the world made the attempt to protect their beet sugar interests against the maladjustment in the world's markets.

Speaking of the unbalanced sugar situation and of government intervention through tariffs, quotas, and bounties, the League of Nations stated in 1935:

> The sugar market is greatly complicated by national tariffs, quotas and bounties. The "free market" which at the beginning of the depression absorbed about six million tons, in 1934–1935, consisted only of the United Kingdom, India, China, and a number of smaller countries in which local production was negligible. It consumed, therefore, less than 3,000,000 tons out of a total world production of about 26 millions. The remainder was subject to national regulation.[7]

Maladjustments in the Domestic Market

The net effect of this maladjustment in the world sugar situation upon the producers and processors in the continental United States, in the Territory of Hawaii, in Porto Rico and the Philippine Islands, was felt in the slow but persistent decline in the price of raw sugar received by them from the postwar high (except 1919–1920) of 7.02 cents in the year 1923 to the extreme yearly low of 2.92 cents in the year 1932. This decline took place in spite of the fact that the full duty on sugar of 2.5 cents per pound was the highest rate since 1883. In short, the policy of the Federal Government to support the sugar industry by a tariff system failed under the impact of a disintegrating world price situation. The constant increase in the tariff under the world conditions outlined above had the effect of causing certain forces to operate in the sugar industry which militated against the success of that tariff.

These forces which worked to bring about an aggravated condition in the United States sugar market are outlined in Table I, which presents for the years 1923 and 1932 the basic data with respect to the amounts of sugar supplied in the American market by the main contributing areas. The data show that between the years 1923 and 1932 there was an increase in the total annual supplies to the American market of approximately 486,000 tons, or 9%. During this period, the producers of beet sugar in the United States, found principally in the western irrigated agricultural areas and in Louisiana, in-

TABLE I

SUPPLIES OF SUGAR TO THE AMERICAN MARKET FROM VARIOUS AREAS, AND PRICES IN 1923 AND 1932

	Supplies (in Thousands of Short Tons and as Percentages of Total)							*Prices*
			Insular Areas of the United States					
	*Total Supplies**	*Continental United States Beet and Cane Sugar†*	*Total Insular*	*Hawaii*	*Porto Rico*	*Philippines*	*Cuba and Others‡*	*Prices—Duty Paid N. Y. C. Yearly Average*
1923	5,354 (100%)	1,227 (22.9%)	1,020 (19.1%)	515 (9.6%)	281 (5.2%)	222 (4.1%)	3,105 (58.0%)	7.02 cents
1932	5,840 (100%)	1,382 (23.7%)	2,786 (47.7%)	957 (16.4%)	851 (14.6%)	974 (16.6%)	1,672 (28.6%)	2.92 cents

* Supplies are for consumption in United States, not production in various areas.
† In the two years beet sugar represented 83% of the total U. S. production.
‡ The other foreign countries supply a nominal amount of sugar, less than 1% a year on the average.

Sources of Basic Data: *Report to the President on Sugar*, Report No. 73, United States Tariff Commission, 1934, Tables 4 and 5, p.38; Supplies Data and Table 24 a, p. 176 for price data.

[7] *Ibid.*

creased their output by 155,000 tons, or 13%. Speaking roughly, the continental producers held their relative position in the industry in terms of its long-time growth. However, during the same nine-year period, with an increase in tariff and in the face of falling prices and an unbalanced world situation in the commodity, the insular areas increased production by 1,764,000 tons, or 172%. This increase in the insular areas, however, was not shared equally between various islands as is indicated below:

TABLE II

SUPPLIES FROM THE UNITED STATES INSULAR AREAS AND CUBA, 1923–1932

Relative Changes in the Supplies between 1923 and 1932

1923 = 100

	Hawaii	*Porto Rico*	*Philippine Islands*	*Total Insular*	*Cuba*
1923	100	100	100	100	100
1932	186	304	438	272	54

The effect of the increase in production in the insular areas was to narrow the American market to the producers of Cuban sugar. During this nine-year period, Cuban producers lost in that market 1,433,000 tons of sugar (Table I). At the same time they found themselves confronted by an increasingly narrowing demand in the world's market, primarily European. Confronted with these conditions in the United States and in Europe, the sugar industry in Cuba underwent a fundamental and drastic curtailment in its production and exports. From the postwar high production figure in the 1924–1925 crop year of over 5,741,000 tons, the readjustment in production, brought about largely by the international agreement, called for a supply under 2,300,000 tons in the 1932–1933 crop year.

It should be noted that the increase in the production of sugar in Porto Rico and the Philippine Islands did not result primarily from an expansion in the acreage under cultivation but resulted from (a) larger cane tonnage per acre grown (through the substitution of new cane varieties); (b) increased sucrose content in such cane; and (c) improvements in milling which brought an increase in the amount of recoverable sugar from the cane.[8] For example, in the Philippine Islands, between 1923 and 1931, the increase in the amount of sugar available for the United States was 243%; however, during that interval the area planted to sugar cane increased by about 13%.[9]

In addition to these rapid changes in technical factors affecting production and milling, which brought about the substantial increases in the output of sugar in the American insular areas, there was a general desire on the part of the plantations to increase production in order that the decrease in price might be offset partially by larger output. The production of sugar cane on a plantation basis, utilizing large investment in plant, railroad, irrigation equipment, and drainage systems, is such as to bring immediate benefits by the spreading of the overhead expense over a larger volume of production. In sugar, as in the case of wheat production in Canada and the United States, the general effect of decreasing prices was not such as to bring about a de-

[8] This trend toward greater agricultural and industrial improvement in the sugar industry is disclosed in Porto Rico as follows:

	Tons Cane per Acre	*Tons Sugar per Acre*
Average 1918–1919 Crop Years	18.75	1.86
Average 1927–1928 Crop Years	23.91	2.74

Source: *Puerto Rico Year Book*, 1933, p. 30.

[9] Hearings before the Committee on Finance, United States Senate, on S. 2732, p. 105.

crease in production, but rather an increase. In short, economic balance of the sugar industry, in the United States and throughout the world, was not regained by the operation of the competitive force of lower prices.

The Failure of the Tariff System of Control

In the year 1933, at the time of the passage of the Agricultural Adjustment Act, it was evident that tariff protection to domestic producers could not offset their loss of income arising from maladjustments in the supply and price of sugar. This was expressed by the Tariff Commission, after making an intensive study of tariff, cost, and price of sugar in 1933:

> (4) . . . That a change (upward) in the duty rate alone would not settle the chaotic condition in the sugar industry, since the supply of sugar available for the American market is so great and the competition to supply the American market is so keen as to depress the market price far below cost. Thus, while the three-year average cost of producing 96° raw sugar in Cuba, plus transportation to Atlantic and Gulf refiners, was 1.923 cents per pound, the average cost and freight price at New York was only 0.925 cents per pound in 1932 and 1.208 cents per pound in 1933.
>
> (5) . . . That the most effective way, based on the information ascertained by the investigation of the Commission, to improve the situation, both in Cuba and in the United States, is to lower the Cuban duty, and at the same time adjust the market demand deliveries of sugar not only from Cuba, but from all other areas contributing to the American supply. . . . [10]

It was believed generally, by the government and the industry, that planning for the sugar industry by means of a tariff was not only ineffective but positively harmful, and that it was necessary that a new method of planning be established, namely, through an adjustment of the market supplies from the various areas to the demand of the American market by means of a quota system. The proposal to scrap the tariff system and to substitute a new method of control, the quota system, was the parallel of the development which had taken place throughout the world in the relationship of the government to the sugar industry. In every important producing and consuming area, between the World War and 1932, there was an increasing disposition to abolish the tariff system as a method of control and to direct aid in the form of quotas, bounties, or outright subsidies. In taking cognizance of the collapse of the old method of control, the United States was following the general trend found throughout the world with respect to this commodity.

Industry and Government Propose a New Method of Control

The original Agricultural Adjustment Act did not include sugar beets or cane as basic commodities[11] and consequently the Secretary of Agriculture could not enter into benefit payment contracts for the control of the production of sugar beets (and cane) and for the regulation of the marketing of raw sugar. A possible mechanism, however, for the establishment of a quota system before the enactment of the Sugar Act itself (May, 1934) was found in Section 8 (2) of the Agricultural Adjustment Act, which provided that the Secretary of Agriculture could "enter into marketing agreements with processors, associa-

[10] These conclusions (partial) were made in 1934 by the Tariff Commission after its investigation under Section 332 of Title III of the Tariff Act of 1930, as reported in the *Report to the President on Sugar*, Report No. 73, pp. 2, 3.

[11] The basic commodities were listed as follows: wheat, rice, corn, cotton, tobacco, hogs, and milk and its products.

tions of producers, and others engaged in the handling, in the current of interstate or foreign commerce, of any agricultural commodity or production thereof. . . . " In addition to this power, the Secretary could issue [Section 8 (3)] licenses to enforce such market agreements as made by him.

The sugar industry in the summer of 1933 established a Sugar Council for the purpose of coöperating with the Secretary of Agriculture in the drafting of a marketing agreement (the Sugar Stabilization Agreement) which should embody the principles of the quota system. The development of this agreement followed public and informal hearings in which the industry (including farmers, processors, and refiners from all areas) placed before the government the difficulties surrounding it, and requested that the powers available to the Secretary under the Agricultural Adjustment Act be employed to wipe out the maladjustments which had arisen in the industry under a system of free competition within a tariff. Specifically, it requested the Secretary of Agriculture to issue a license covering the industry (in addition to the signing of the marketing agreement), in order that the so-called recalcitrant members of the industry be placed under control for the efficient administration of the plan. In short, the industry requested regulation under government supervision.

The proposed agreement was submitted to the Secretary of Agriculture on August 22, 1933, and in October he announced that the agreement was not acceptable to the government. In general his reasons for not accepting the document were that it did not adequately protect the interests of farmers and consumers, and did not provide an effective method for the control of production in the various areas.[12]

After the agreement was scrapped, representatives of the industry and of the government continued in their efforts to develop a program which would be satisfactory to all groups. The results of this effort were embodied in a message to Congress from the President on February 8, 1934.[13] In this message the President stressed the maladjustments that had occurred under the competitive tariff system, but stated, "I do not at this time recommend placing sugar on the free list." It was stated that any plan for the sugar industry should equate yearly supplies to estimated demand, adjust cane and beet production, assure domestic producers of a fair return upon their "restricted output," protect the insular areas, and contribute to the economic rehabilitation of Cuba.

The message indicated that these objectives could be reached by amending the Agricultural Adjustment Act in two important regards, *i.e.*, by giving the Secretary of Agriculture, through the power to issue orders and regulations, the right to restrict the importation and distribution of sugar to the American market through a quota system, and to place a processing tax of half a cent a pound on sugar. In addition, other steps could be taken by reducing the tariff on Cuban sugar under the flexible tariff provision of the Tariff Act and by the execution of a trade treaty between the United States and Cuba under the Reciprocal Treaty Act.

An examination of the hearings on the Jones-Costigan amendment to the AAA, which was to implement the re-

[12] A detailed statement of the Secretary's position is found in an official press release of the Agricultural Adjustment Administration on October 9, 1933.

[13] Quoted in full in the *Hearings Before the Committee on Finance*, U. S. Senate, on S. 2732, p. 3.

quest of the President for a quota system, discloses the complete assent to the general plan by the representatives of the various agricultural producers, processors, and refiners. A new method of planning was to be substituted for the old, but it was recognized by all interests that the new method would necessitate a tremendous expansion of the powers of the Federal Government over the economic functioning of the industry. Industry placed power in the hands of the Secretary of Agriculture to direct an ambitious plan for the rationalization of sugar. Business leadership was willing to work within the scope of that plan.

The Administration of the Quota System

The Adjustment of Immediate Supplies to Consumption. The foremost problem in the administration of the quota system was that of equating immediate market supplies of sugar to the consumptive demands on a yearly basis. The problem of estimating consumption was simplified by the fact that such consumption is almost entirely in the domestic market.[14] Furthermore, such consumption is stable relative to the consumption of other basic commodities. Consequently, it was a relatively easy task for the Secretary of Agriculture to estimate the requirements for the first quota year, 1934. When the estimate was announced at 6,476,000 tons, there was substantially no criticism expressed by the members of the trade as to the accuracy of that figure. It was accepted that the estimate could be made by the government as well as by any private organization.

Pursuant to the provisions of the Sugar Act, the next step was to divide the estimated market requirements (consumption) among the various producing areas. To assist the Secretary of Agriculture in this, Congress had laid down the rather broad and vague standard that the division among the areas, except in the case of domestic beet and cane areas, should be "based on the average quantities therefrom brought into or imported into continental United States for consumption . . . during such three years, respectively, in the years 1925–1933, inclusively, as the Secretary of Agriculture may, from time to time, determine to be the most representative respective three years. . . . " This formula was not to be applied to the domestic beet and domestic cane areas inasmuch as they were provided for by Congress. The quotas established for the year 1934, in the matter described above, are given below:

	Short Tons
United States—beets	1,556,000
Louisiana and Florida—cane	261,000
Hawaii	917,000
Porto Rico	803,000
Philippine Islands	1,015,000
Virgin Islands	5,000
Cuba	1,902,000
Full duty countries	17,000
Total	6,476,000

The next problem was one of enforcing these quotas as established. This raised the general question as to whether restriction should be implemented (*in toto*) without respect to individual processors or importers, or through an allotment system wherein each sugar processor would receive his share of the quota. The advantage of the first method was in its simplicity and in the ease of operation. The disadvantage, however, was obvious, in that if allotments were not made to individual processors within the various areas, advantage would be gained by

[14] The export of sugar (refined) is negligible (about 2%–3% of the domestic consumption).

those individuals who sold their sugar first, leaving the late sellers without their equitable share of the quota. This disadvantage was particularly apparent inasmuch as the amount of sugar available for immediate distribution for the various areas for the year 1934 was in substantial excess of the quotas. The following table indicates roughly the extent of these excesses:

SUGAR (RAW)
Differences between Estimated Production 1933–1934 and Official 1934 Quotas

United States—beets	+209,000 tons
Louisiana and Florida—cane	− 56,000 "
Hawaii	+112,000 "
Porto Rico	+178,000 "
Philippine Islands	+441,000 "
Virgin Islands	+ 3,000 "
Cuba	+691,000 "

Source: *Foreign Crops and Markets*, July 30, 1934, p. 115.

Although Congress had given the Secretary a general standard to follow in the establishment of quotas, it had not provided a mathematical standard for the division of the quotas among processors under an allotment system. Obviously, the granting of such allotments was a direct and immediate "interference" with the business rights of processors in the various areas involved; and, with a lack of standard, the establishment of such allotments placed the Secretary of Agriculture in a delicate administrative and legal position. As a matter of policy, the processors in each area were invited to agree among themselves on an equitable formula for the division of the allotments and report such decision to the Secretary. With the exception of processors in the Philippine Islands and the Territory of Hawaii, agreements were not reached; the Secretary was forced, therefore, to make allotments in light of the circumstances existing in each area. The processors of Porto Rico and the beet factories of the United States, being unable to reach an agreement as to the allotments of the quotas, willingly placed this power in the hands of the Secretary of Agriculture on the grounds that he would arrive at a formula which was fair and equitable. Industry called upon government to force "industrial coöperation."

After due notice and opportunity for hearing, such allotments of the various quotas were made by the Secretary and the excess of sugar available from the producing areas for the American market, in the neighborhood of 1,000,000 tons, was stopped from entering the channels of consumption and was stored for distribution in the quota year 1935.[15] Within two months after the passage of the act, the sugar industry saw the balancing of immediate supplies to the probable demand for the calendar year 1934.

The Adjustment of Production of Cane and Beets to (Sugar) Quota Levels. After the balancing of immediate supplies to demand, it was necessary to adjust the production of beets and cane in the areas involved. The necessity of such adjustment of agricultural production of beets and cane in the continental United States, and of cane in the three offshore areas, arose from two reasons: first, production had to be adjusted to the quota (marketing) level for 1935 for each area; and secondly, adjustment was necessary in order that the excessive stocks of sugar, primarily held in the Philippine Islands and in Porto Rico, be reduced. This adjustment in basic supplies for the year 1935 was accomplished through a series of benefit contracts which were entered into by the Secretary of Agriculture and the producers of sugar beets in the United

[15] In Cuba, an agency of the central government made allotments to processors for shipment to the United States.

States, and the producers of cane in Louisiana and Florida, in the Territory of Hawaii, in Porto Rico and the Philippine Islands. These contracts differed for each area in their detail inasmuch as the economic and agricultural situations prevailing in those areas are different. In the main, however, one characteristic was found in all areas. Although there were thousands of producers to be reached in each area, nevertheless those producers were grouped into producing areas, the center of which was a sugar mill. Sugar beets and sugar cane, unlike cotton or corn, are not sold to miscellaneous purchasers for cash, but are sold under contracts to the mill or factory which is the natural processor of the farm product involved. These economic and industrial facts peculiar to the sugar industry made it possible for the Secretary, within a short period of time, to enter into contracts with producers for the control of their cane and sugar output. Over 200,000 producers of sugar, scattered from Porto Rico to the Philippine Islands, were placed under production control plans within six months. The effectuation of such control would have been difficult, if not impossible, if the processors of sugar (beets and cane) had not coöperated in the administration of the program.[16]

The technique of the adjustment of production in the case of sugar cane brings to the front the general question of the ability of the government to plan agricultural production. Wide currency has been given to the opinion that production control is impossible, or at least ineffective, due to the wide and unpredictable variation in growing conditions, *e.g.*, drought. The validity of this general opinion calls for a close examination of the facts relating to each crop. It is clear, however, that it does not hold in the case of sugar. The reason is that the factors affecting the amount of sugar cane grown in various areas are largely dependent upon the growing acreage, the application of water (in the case of the irrigated areas of Hawaii and Porto Rico), and the amount of fertilizer which is applied. These three factors are within human control. Secondly, sugar cane in Porto Rico and Hawaii can be "carried over" in the field from one crop year to the next and production, in a sense, can be postponed. Thirdly, the main producing areas of sugar cane and sugar beets for the American market are so widely scattered, from Porto Rico to western United States, Hawaii, and the Philippine Islands, that any act of God, such as drought or hurricanes, would not have the effect of reducing generally the total amount of sugar available for the American market on a yearly basis. Consequently the drought in the beet area in the fall of 1934 did not jeopardize the supply of sugar in the United States in 1935.

In order to take adequate precautions that the American market would not find itself with a scarcity of sugar due to possible fluctuations in the size of the crop under the adjustment program, adequate reserves were established in various areas. The establishment of these reserves of sugar, approximately 10% in all areas, was possible due to the existence of ample storage capacity and the ease with which raw sugar may be stored.

Because of the large crops of sugar in the Philippine Islands and Porto Rico

[16] In Porto Rico, Louisiana, Florida, and Hawaii (but not in the beet area or the Philippine Islands) processors of cane are also producers, and hence they signed benefit contracts for the adjustment of the production and milling of their own cane and the milling of all their purchased cane.

in the year 1934, and because of the restrictions of the supplies from these areas in the first quota year 1934, there was in existence a substantial amount of "over-quota" sugar as of the first of January, 1935. In order that these excesses of supply, which had arisen under the old tariff system, might be absorbed, the agricultural adjustment programs in the Territory of Hawaii and in Porto Rico and the Philippine Islands called for an emergency limitation of the use of a part of the sugar cane of the 1935 crop. (This crop was growing in May, 1934, the date of the passage of the Sugar Act.) This limitation, however, did not take the form of a physical "destruction" of the crop, but was obtained by the diversion of part of the crop to secondary uses, namely, through its conversion into high sugar content molasses and as feed for livestock. Furthermore, through the application of less cultivation, irrigation, and fertilization, the size of the crop and its sugar content were reduced. The essential features of the Sugar Act did not call for a destruction of property, but rather for an adjustment. It was only in the first year of the act that it was necessary to take such stringent action with respect to the adjustment, but even this action avoided in large measure the destruction of a basic food crop.

The Substitution of a Direct, for an Indirect, Subsidy. The benefit contracts, entered into with the producers in the six areas involved, called for payments to these producers for an adjustment of their production. These payments to the producers in the continental United States beet and cane areas were based upon the principle as outlined in the Agricultural Adjustment Act, namely, that payment could be made equal to the difference between the actual price received per ton of beets and cane and the "fair exchange value thereof," *i.e.*, the prewar farm price adjusted upward to offset the increase in prices paid by farmers.[17]

Inasmuch as the amount of the restriction of production for the continental producers was relatively small because of the ample quotas which they had received from Congress, the payment of fair exchange value represented a direct sugar subsidy. There was a restriction on the expansion (in the words of the President) of "this necessarily expensive industry" as a *quid pro quo* for the receipt of fair exchange value. For the domestic producer, an indirect subsidy of the tariff system became the direct subsidy of the quota-benefit contract system. Through his contract with the central government, he was called upon to meet certain obligations, the outstanding one being the limitation of output to allotments.

The payments to producers in the insular areas were not based upon the "fair exchange value" principle. By the provisions of the act, the proceeds of the processing tax of one-half cent a pound upon the sugar produced from the various insular areas were set aside for the purpose of making payments to insular contract-signing producers or for "the general benefit of agriculture" of these areas. Funds were not available from the one-half cent tax in an amount sufficient to pay a subsidy of "fair exchange value" to all insular producers. This differentiation by Congress of the amount of payments which could be made to the producers in the insular areas, as contrasted with the domestic producers, was an adoption of a new

[17] Following this formula, $2.26 and $1.75 per ton of cane and beet, respectively, were paid to continental producers (contract signers) upon their 1934 tonnage.

policy with respect to these insular areas. Under the old tariff system, benefits of the tariff were experienced alike by all producers within the United States tariff area. By means of varying payments to the producers in the offshore areas, as contrasted with domestic producers, less governmental assistance was afforded to those areas which had lower costs. In short, the tariff system gave equal protection to all areas, whereas the quota system afforded opportunity to vary the protection, through a direct subsidy, as between the different producing areas.

The fund from which all payments were made under the adjustment contracts, discussed above, was derived from a processing tax of one-half cent per pound upon the refining of raw sugar. Congress directed the Secretary to levy the necessary processing tax up to, but not in excess of, one-half cent per pound. In the establishing of this processing tax, therefore, the discretionary power of the Secretary was decidedly limited. At approximately the same time that the processing tax was applied upon sugar, there was a reduction by Executive Order of the duty upon sugar under the flexible provisions of the Tariff Act in an amount equal to the processing tax. Consequently, the broad effect of the reduction of the duty and the imposition of the processing tax was to leave the refiner, the payer of the tax, in a position not substantially different from that before the enactment of the Sugar Bill. This meant that the net cost of sugar to the refiner was not substantially changed and, consequently, it was not necessary to change the price of refined sugar as a result of such a tax. The retail price of sugar was not greatly disturbed and the net effect of the tax (and the quota system) upon the consuming public was inconsiderable. (The increase in the retail price of sugar, fifteen months after the inauguration of the quota plan, June, 1934, was 7%.) In addition to this, the amount of raw sugar actually refined by the refiner was not reduced inasmuch as the Secretary of Agriculture was directed to permit the entry of sugar for refining in an amount equal to the consumption of sugar. In the face of these facts, continental sugar refiners (including sugar beet processors) found the plan not disruptive to their industry and gave full coöperation to the Secretary.[18]

The Sugar Plan and Cuba

One of the major objectives of the Jones-Costigan Act, as stated by its proponents, was to contribute to the economic rehabilitation of Cuba by the restoration to that island of a portion of the American market that was lost to the insular possessions by virtue of the tariff policy. Secretary of Agriculture Wallace states, "It (the Sugar Act) also takes into account the obligations of the United States toward Cuba as implied by the Monroe Doctrine and specified in the Platt amendment."[19] With the increase in insular production, Cuba was steadily driven from the American market until in the year 1932 she contributed but 28% of the American supply as contrasted with 58% in 1924. In short, the policy of the Federal Government to give preferential treatment to Cuba over the world with respect to her exports to the United States was defeated by the continual increases in the sugar tariff, which had

[18] This fact was of substantial importance in view of the necessity at all times of receiving accurate and timely statistics from the refiners and beet processors.

[19] Official press release, Agricultural Adjustment Administration, March 16, 1935.

the effect of augmenting the supplies to the American market.[20] The quota system (and the reciprocity treaty) was selected as the method for the changing of this condition. Direct economic realignment was accomplished through political action of the central government.

In the year just prior to the passage of the Sugar Act, that is, 1933, the value of all the sugar shipped from Cuba to the United States was approximately $40,000,000. For the year 1935, the first year after the passage of the act, the value of Cuban sugar sent to the United States is estimated as twice that amount. This increase in the net value of the sugar sold to the United States has occurred for three reasons:

(1) The quota system established a quota for Cuba in the years 1934 and 1935 at, roughly 1,900,000 tons of sugar. In the year 1933, the actual amount of sugar from Cuba which found its way into a narrowed American market was 1,601,000 tons.

(2) The duty on Cuban sugar was reduced from 2 cents to 1½ cents by Executive Order in May, 1934. In 1934, there was a further reduction to 0.9 cents per pound under the provisions of the Reciprocal Trade Agreement, which was signed by the United States and Cuba pursuant to the Reciprocal Trade Agreement of 1934.[21]

(3) Due to the operation of the Jones-Costigan Amendment, the price of Cuban sugar imported into the United States, before consideration of duty, is higher than the equivalent world (London) price. In 1935 this premium has ranged approximately from one-tenth of a cent to about seven-tenths of a cent per pound.

[20] By the terms of the Cuban Reciprocity Treaty (1902) a 20% preferential tariff rate on sugar was enjoyed by Cuba.

It is clear that by the terms of the Jones-Costigan Amendment and the Cuban Reciprocity Treaty, the interests of Cuba are more directly protected than has been the case in the past. The economic adjustments in Cuba which would arise from a nullification of the Sugar Act and the Trade Treaty, by either court or legislative action, are obvious. By the terms of these documents, Cuba is taken more firmly within the economic orbit of the United States, and a drastic change in those relationships would call for a realignment in her economic life. By the nature of our political institutions, no assurance can be given that these relationships will be continued as they now exist.

Tentative Conclusions

The experience of the creation and administration of the Sugar Act cannot be used to draw fast and hard conclusions as to the wisdom or expediency of the government extending its power over the planning and direction of any basic industry. However, that experience does afford an opportunity to draw some generalizations with respect to this problem.

First, under the tariff system the government had directly assumed the responsibility of controlling, in a rough fashion, the price and production of sugar. With the failure of that system, it was natural that the government be called upon to take steps to rectify the definitely unbalanced sugar situation. The Sugar Act was designed to meet an inherited problem, and was not designed to extend the power of the government for power's sake. It is to be expected that the government

[21] The Act H. R. 8687 is an amendment to the Tariff Act of 1930.

be called upon to extend its control over industries which have in the past accepted the generous support of the public through the tariff or other subsidy.

Secondly, all groups in the sugar industry knew that the quota system of control necessitated a substantial sacrifice of property rights. Business leadership does not necessarily revolt against the increase in governmental power if it is clear, or even probable, that such an increase is necessary to restore some degree of stability to industry, and there is promise of it doing so.

Thirdly, in creating and administering the sugar plan it was impossible to divorce that plan from the economic, political, and social conditions which had developed under private initiative and tariff protection. Legitimate interests developed under the old could not be wiped out by the new. It can be said that all plans which may be proposed for the direction of industry under government supervision must be in the nature of a compromise and must be grounded firmly on the facts as they exist. Such planning cannot go ahead faster than this historical background will permit. An important part of this background is the disposition for cooperation on the part of the business interest affected. Economic planning by means of blue print must be of a very limited nature in face of the facts of a democratic United States.

Fourthly, the central government has been able to exert a far-reaching control over the production and distribution of sugar cane and beets (and sugar) without affecting substantially the day-by-day activities of the industry. Government interference need not retard business enterprise and initiative.

Fifthly, in the administration of the Sugar Act, it was apparent at all times that the proponents of the plan had not seen the many problems which would arise in its execution. Fortunately, the act provided a large measure of flexibility and broad discretionary powers for the administrator. Such flexibility was essential in order that there be an effective execution of the provisions of the act. If it is necessary that industry operate under Federal direction under a broad plan, it is likewise necessary that flexibility be provided. In the future, government and business will be faced with the difficult question of obtaining effective administration and, at the same time, of protecting the individual and property rights of the persons affected.

The age-old problem of the best arrangement of the relationship of men to the central government has been complicated by the events of our modern industrial-political life. The answer to this problem, either by government or by business, may be reached after patient examination, and by trial and error; it cannot be reached if the facts of that life are disregarded.

FACTORING

BY OWEN T. JONES

IN recent years we have witnessed a growing interest in the activities of the factor. Long known to the textile industry, and one of the oldest forms of financing, it was not until recently that the factor evolved into a financial agent for trades other than textiles. The specialized nature of the service and the great attention to detail have contributed to the lack of understanding of the nature of its operations. Once the aura of mystery is dispelled, however, we find a financial agent of long tradition and experience rendering a service unique only in its method of operation and in its breadth.

EXHIBIT I
THE FACTORING RELATIONSHIP

Definition and Functions. Factoring, in its simplest form, consists of the discounting of sales and the assumption of credit risks. In its broader aspects it performs the following functions: (1) provides working capital by discounting sales, (2) eliminates credit losses by assuming credit risks, (3) renders merchandising assistance by means of market contacts and styling and selling experience, (4) provides certain auxiliary services required by clients in connection with finances and sales. We have here a breadth of service not ordinarily furnished by financial institutions, but, as we shall presently see, this arises from the unique background and evolution of the factor.

Increased Recognition. It was not until "factored receivables" appeared, first in 1928, on the financial statements of the publicly held Commercial Investment Trust, and, later in 1933, on the statements of Commercial Credit Company—the securities of which were also publicly held—that factoring became a subject of interest beyond the textile field. Meanwhile, the service began to expand into other industries, a movement to which the depression gave impetus. The total factoring volume of reporting houses increased from $344,980,000 in 1928 to $542,510,000 in 1933.

As the service has expanded it has come more and more to the attention of the business man. In its direct bearing on his own business, it stands as an important means by which he may increase his working capital, may be afforded relief from financial, credit, and collection worries, and may be permitted to devote his entire time to merchandising and selling. Moreover, the business man has found himself extending credit to more factored concerns, or, as the result of buying

from such concerns, he has had to make more and more remittances for such purchases to a factor rather than to the supplier.

The Factor's History and Evolution

The Factor's Evolution. Factoring had its origin in the early English agent abroad who received merchandise from English mills with the authority to act for them in the foreign sale. The mills naturally endeavored to hold the agents responsible for the foreign credits so that as the agents' business grew they came to guarantee these credits. As these agents became stronger the mills also turned to them for money to be advanced pending (1) the sale of the merchandise in the agent's possession, and (2) the maturity of existing receivables. These two types of advances later became clearly differentiated into advances on merchandise and the discounting of sales.

The business of these agents expanded and American mills sought their services for domestic business. In the United States there evolved the commission merchant, also known as a factor, that acted as a merchandising and financial agent for foreign and domestic mills in the various divisions of the textile field. For the last century these large and widely known commission merchants represented the very lifeblood of the textile industry. During the last quarter century, however, there was a gradual separation of the merchandising and financial functions. Many of the old commission merchants turned exclusively to the financial function, and the term "factor" came to refer only to such houses offering the service of discounting sales, advancing funds, assuming credit risks, and collecting accounts. There developed, in turn, the selling agent who attended strictly to the merchandising function, and who, in many cases, maintained an independent but close connection with the modern factor who would provide the financial service that the selling agent's mills required.

The history of most of our large modern factoring houses reveals this early beginning as commission merchants. Four of these houses had such an origin prior to the middle of the nineteenth century: William Iselin & Co., Inc., being founded in 1808; Rusch & Co. in 1827; Fred'k Vietor & Achelis and Schefer, Schramm & Vogel, both of which are now a part of the Commercial Factors Corporation, in 1828 and 1838 respectively; and L. F. Dommerich & Co. in 1839. In each case the dual rôles of financing and merchandising were finally discontinued in favor of the strictly financial rôle. There still remain, however, some of the old type commission houses. Furthermore, in the textile industry the factoring service is offered in a limited way by parent concerns to their affiliates or by private

EXHIBIT II

FACTORING

	Number of Concerns	*Number of Employees*	*Invested Capital*	*Annual Sales*
1928	16	1214	$39,770,000	$344,980,000
1929	17	1544	51,760,000	485,220,000
1930	17	1664	50,600,000	505,450,000
1931	17	1699	50,480,000	490,750,000
1932	18	1696	49,940,000	436,830,000
1933	20	1588	46,190,000	542,510,000

Source: Figures submitted to National Recovery Administration.

interests to a few of their mills. It is, consequently, difficult to gauge accurately the total volume of factoring actually done.

The Factor in Law. Concomitant with this evolutionary growth of the modern factor, there developed in early English common law and in our American statutes a voluminous set of principles definitely recognizing the legal position of the factor. In New York State, where virtually all of the factoring organizations are located, the law treats extensively with the subject, and in Sections #43 and #45 of the Personal Property Law special recognition is accorded to such matters as the factor's lien and the factor's rights as consignee.

It has not been until recently, however, that our legal parlance has recognized the difference between the modern usage of the term "factor" and the old usage embracing the selling function. As late as 1924 the New York State Court of Appeals said in a leading case:

> The standard, presumptive meaning of the word factor does include and denote a selling agent.[1]

In another case during 1926 the court was even more explicit:

> The habit of persons who are really commercial banks or financial agents of styling themselves as factors seems very common. In the common law sense of the term a "factor" is an agent to whom merchandise is entrusted for the purpose of sale. If he also guarantees the purchasers credit he is a *del credere* factor. In this case the defendants were in no sense factors. They were simply financial agents in the nature of commercial bankers. They did not sell the plaintiff's merchandise.[2]

In 1931, however, Section #45 of the New York State Personal Property Law was amended as follows:

> The terms "factor" and "factors" wherever used in this section include any consignee or consignees . . . whether or not such consignees . . . are employed to sell such merchandise. . . .[3]

In 1933 in an important decision, although still maintaining the distinction between the old common law concept of "factor" and the newer statuatory definition, the court stated:

> The definition of factor may have to yield to "commercial and trade usages and understandings" . . . where . . . the word factor may no longer . . . indicate a person enjoying the powers and bearing the responsibilities of a selling agent.[4]

The Leading Factors. As a result of this evolutionary growth of the factoring business, we now have a number of houses of varied size and character offering the service. A few of those shown in Exhibit III may still sell some merchandise, but most of them are strictly factors in the modern sense of the term. All of the names shown are either partnerships or closely held corporations, except for the three wholly owned subsidiaries of Commercial Investment Trust and the two wholly owned subsidiaries of Commercial Credit Company. In each instance, however, these five

[1] *Shoyer et al.* v. *Edmund Wright-Ginsberg Co.*, 148 N.E. 328, 240 N.Y. 223, modifying judgment (1924) 206 N.Y.S. 421, 210 App. Div. 645.
[2] *Lemnos Broad Silk Works, Inc.* v. *Spiegelberg*, 217 N.Y.S. 595, 127 Misc. Rep. 855.
[3] McKinney's Consolidated Laws, Personal Property Law Section #45 addenda: "seventh paragraph new. Added by L. 1931, ch. 766, in effect Apr. 25, 1931."
[4] *Irving Trust Co.* v. *B. Lindner & Bro.*, 190 N.E.: 332, 264 N.Y. 165, mod. 267 N.Y.S. 964, 240 App. Div. 879, rearg. deu. 191 N.E. 621, 264 N.Y. 675.

subsidiary companies are managed by an independent executive staff which represents without break of continuity the original management.

In the absence of sales figures the relative size of the different factors cannot be accurately determined. It is generally recognized, however, that of the houses shown in Exhibit III, the five doing the largest factoring business are Commercial Factors Corporation, L. F. Dommerich & Co., William Iselin & Co., Inc., James Talcott, Inc., and the Textile Banking Company, Inc. It is also estimated that over half of the present factoring volume is done by the wholly owned subsidiaries of Commercial Investment Trust and Commercial Credit Company. Factoring, in turn, as will be seen from Exhibit IV, represented approximately 33% of Commercial Investment Trust's total 1934 volume, and "factored receivables" represented approximately 14% of the total outstandings at December 31, 1934. With Commercial Credit Company these figures were approximately 26% and 11% respectively.

EXHIBIT III

FACTORS

C. A. Auffmordt & Co.	Crompton-Richmond Co.	Mill Factors Corporation
Bachmann Emmerich & Co., Inc.	L. F. Dommerich & Co.	Reiss Factors Corp.
*Barnard Phillips Factors, Inc.	‡Edmund Wright-Ginsberg Corp.	Rusch & Co.
H. A. Caesar & Co.	H. M. Hubshman & Bro.	Shapiro Bros. Factors Corp.
Century Factors, Inc.	†William Iselin & Co., Inc.	James Talcott, Inc.
Coleman & Co.	†Meinhard, Greeff & Co., Inc.	‡Textile Banking Co.
†Commercial Factors Corp.		

* Wholly owned subsidiary of James Talcott, Inc.
† Wholly owned subsidiary of Commercial Investment Trust, Inc. ‡ Wholly owned subsidiary of Commercial Credit Company.
Source: Houses represented at factors' group meetings, New York City.

EXHIBIT IV

CLASSIFICATION OF OUTSTANDINGS AND PURCHASES

Commercial Investment Trust

	Purchases for Year Ended Dec. 31, 1934		*Receivables Outstanding on Dec. 31, 1934*	
1. Retail Automobile Installment Lien Notes	$224,819,362	28.8%	$124,697,777	64.3%
2. Wholesale Automobile Lien Notes and Acceptances	259,000,608	33.2	14,003,629	7.2
3. Accounts Receivable of Factoring Companies	254,972,370	32.7	27,907,268	14.4
4. Industrial Installment Notes (other than automobiles)	38,995,174	5.0	27,312,123	14.1
5. All Foreign Receivables	1,961,734	0.3		
	$779,749,248	100.0%	$193,920,797	100.0%

Commercial Credit Company

	Purchases for Year Ended Dec. 31, 1934		*Receivables Outstanding on Dec. 31, 1934*	
1. Motor Lien Retail Time Sales Notes	$ 96,148,070	25.4%	$ 54,419,516	56.6%
2. Motor Lien Wholesale Notes and Acceptances	127,980,003	33.9	11,176,967	11.6
3. Open Accounts, Notes, Acceptances, and Rediscounts	134,984,849	35.7	*15,355,743	16.0
4. Industrial Lien Retail Time Sales Notes	17,178,463	4.6	14,968,071	15.6
5. All Export and Foreign Receivables	1,667,646	0.4	161,903	0.2
	$377,959,031	100.0%	$ 96,082,200	100.0%

* Includes $10,948,055 Factored Receivables.
Source: Annual Reports to Stockholders.

Developments in the Factoring Field. In addition to the entrance of Commercial Investment Trust and Commercial Credit Company into the factoring field, there has been discernible a tendency toward consolidation among factoring houses. The Commercial Factors

Corporation represents a consolidation of Fred'k Vietor & Achelis, Peierls, Buhler & Co., Schefer, Schramm & Vogel, and L. Erstein & Bro., Inc.; Meinhard, Greeff & Co., Inc., is a combination of the Greeff & Co. and Morton H. Meinhard & Co., Inc.; William Iselin & Co., Inc., acquired the business of Fred'k Ludewig & Co. and Fabrics Factors Corporation in 1930, and this year announced the acquisition of the Passavant & Co. business. Within the last year James Talcott, Inc., took over Barnard Phillips, Inc.

On the other hand, we have witnessed during 1934 and 1935 the formation of a number of comparatively small factoring concerns. Most of these are located in New York as are all the large factoring houses because of the city's strategic location in the textile and financial fields. Others, recently organized, have purported to offer for the first time a local factoring service in the Middle West just as we have had some organizations styling themselves "factors" operating on the West Coast. While representing an interesting development in the factoring field, these middle western and far western concerns differ from those located in New York in that they generally service a very specialized trade and lack the breadth of service and background of the eastern organizations.

It will be seen, therefore, that while factoring is an old service, it is keeping abreast with economic development by constant adaptations within its own field. The factors may be further characterized by their diversity in size and background. The principal houses, however, have this momentum derived from the evolution from an early merchandising house to a strictly financial house. In this respect, it is believed, the factor is unique.

The Factor's Functions and Operations

We described the functions of the factor as being those of (1) discounting sales, (2) assuming credit risks, (3) offering merchandise assistance and advice, (4) providing certain auxiliary services required by the client.

The Factor's Contract. These functions are performed under a contract similar to that shown in Exhibit V on page 198. The contracts used by the different factors will vary in detail, but in principle they are, as a rule, virtually the same. This is particularly true in so far as they relate to the first two functions, for which the method of operation is becoming more and more standardized. In regard to the last two functions, however, there will be found considerable variance both in regard to policy and in method of operation.

The Discounting and Credit Functions. The regular business of discounting sales and assuming credit risks is conducted on the "notification" plan. Under this method the face of the invoices sent out by the client carries a factor's notation which reads somewhat as follows:

> This bill is assigned to and payable only to our factors, the A.B.C. Factoring Company, to whom notice must be given of any merchandise returns or claims for shortage, non-delivery, or for other grounds.

Copies of such invoices are sent by the client to the factor together with the express receipts, duplicate bills of lading, or other shipping documents. With this material to authenticate the invoice, and with payments to be made by the customer to the factor,

the latter is then prepared to discount the invoice and handle all collection problems.

Prior to each shipment of merchandise, however, the factor's credit approval must be secured.[5] The flexibility of the credit service of the larger factoring houses meets the requirements of virtually any client in this respect. For clients having New York City offices this approval may be given over the telephone and subsequently approved in writing. For clients outside of New York City teletype facilities or telegraphic codes are used to expedite this work. Where goods are manufactured in advance on order, the factor is prepared to give an advance credit opinion subject to a final approval before shipment. Where immediate shipments out of stock are required lines of credit may be established within which a client may make such immediate deliveries.

Once an approved shipment is made and the merchandise found to be satisfactory and accepted, the client has no further dealings with his customer on this particular transaction. The factor assumes any loss due to insolvency, unless, as in some cases, it has allowed its client to make a few sales on his own risk after refusing to check such credits. In the event, however, there is a failure to pay because of a merchandise dispute, the factor may charge such an account back to the client. Under such circumstances, the factor is prepared to assist in the settlement of such disputes, and when they are palpably devices to cover actual insolvency the factor will assume such risks.

Upon receiving the copy of invoice and the supporting shipping documents, the factor is prepared to advance cash on the amount of such invoices less a small reserve as protection against returns, charge-backs, and other contingencies. Some clients take the money as fast as the invoices go through. Others get only enough for pay rolls and current bills until the monthly accounting when the factor ordinarily sends them a check for the equity in their account. Still other clients prefer to carry a credit balance with the factor. This the factor cannot profitably permit, and, ordinarily, is prepared to do so only by creating a special account in which such balances may be carried at an interest rate considerably below that of the regular account.

These transactions are all recorded in the account—called "Account Current" in Exhibit V—between the factor and the client. This account is generally rendered monthly, as of the end of the month, with interest compounded semiannually. Most factoring concerns compute this interest at 6% per annum on both debit and credit entries. At the end of the month the value of the sales of that month is credited to the account, a procedure having

[5] The factor's credit information about the client's customers is built up principally from three sources: (1) reports of such agencies as Dun & Bradstreet, National Credit Office, etc.; (2) information from other factors, from banks, and from the trade in general; (3) the factor's own contact with the customer.

The credit agencies have within recent years so broadened and improved their service that their reports now constitute an important base from which most credit checking begins. The close manner in which credit men, as a group, work together permits the ready interchange of information not immediately available from the agencies or not given in their reports. Finally, the factor's strategic position often makes available confidential information not issued elsewhere. This is particularly true where several of the customer's important sources of supply use the same factor. Under such circumstances it is essential for the customer to establish proper credit with that factor in order to obtain such supplies.

the effect of throwing the account back into a credit position from the accumulated debit position created by checks issued to the client during the month. For those clients taking money as fast as shipments are made, or prior to the end of month accounting, the factor maintains a memorandum account showing current debits and credits arising from the daily sales and checks issued.

The value of the month's sales credited to the client's account is calculated and reported in a separate statement also rendered monthly and referred to as "Account Sales" in Exhibit V. Calculating the value of the month's sales as of the end of the month involves finding the average maturity date of such sales, adding ordinarily ten days for collection and slow payment, and anticipating from such average due date to the end of the month. Deducting the factor's commission we arrive at the amount credited to the client's account. While accounting methods will vary somewhat among the various factoring houses, they are governed by essentially the same principles in arriving at this figure.[6]

It should be noted that in a few instances the account with the client is handled by the factor on a "collection" rather than a "discounting" basis. Under this method the account is credited with the collections as they are made. Because of the additional bookkeeping detail most factors prefer not to handle their accounts on this basis, although in some cases it is necessary because of the peculiar collection problems with certain classes of trade.

[6] Under a discounting arrangement similar to that shown in Exhibit V, we may briefly outline as follows the accounting procedure involved when:

1. Sales are made on July 10 and 18 amounting to $3,000 and $1,000 on terms of net 30 and net 60 respectively.
2. Checks are received by the client on July 11, 19, and 31 for $3,000, $250, and $650 respectively.
3. The client has a credit balance with the factor on July 1 of $364.80.
4. The factor receives a commission of 2% on net sales.

An Account Current will be rendered to the client for the month of July which, giving recognition to the above transactions, will appear as follows:

ACCOUNT CURRENT
Rendered as of July 31, 1935

July 11: Check	$3,000.00	July 1: Balance	$ 364.80
" 19: "	250.00	" 31: Interest	1.82
" 31: "	650.00	" 31: Account Sales	3,899.75
" 31: Interest	9.96		
" 31: Credit Balance Forward	356.41		
	$4,266.37		$4,266.37

The $3,899.75 credited to Account Current from Account Sales will be arrived at as follows:

ACCOUNT SALES
Sales for Month of July

	Date of Invoice	*Amount*	*Terms*	*Due Date*	*Avg. Due Date (Including 10 Days for Collection)*
Sales:	July 10	$3,000	Net 30	Aug. 10	Aug. 31
	July 18	1,000	Net 60	Sept. 18	
Commissions:		80		July 15	

Value of July Sales Aug. 31: $3,920.00
" " " " July 31: 3,899.75

It will be seen, therefore, that factoring, as it relates to the two principal functions of discounting sales and assuming credit risks, really amounts to doing business on a cash basis. The various methods of accounting are incidental to the basic principle that the client may receive from the factor, upon shipment of the merchandise, the value of the invoice in cash just as if he were selling to a cash customer. Thereafter, he is not concerned about the customer's inability to pay. The value of a cash customer is universally recognized. To most business executives such a customer is worth at least a 2% or 3% discount, and therein we have one of the most cogent reasons for factoring as well as an important offsetting saving incident to the service.

The Merchandising Function. The third function of providing merchandising assistance is an intangible one that does not appear in the contract form. It has several aspects. In the first place, the factor has its own actual selling and styling background. Out of this there has been built up a fund of experience on merchandising problems. In the second place, the factor has, through this former merchandising work and through its present close relations with mills, agents, and finishers, unusually broad market contacts. Finally, through its own necessarily large and broad credit department, the factor is in a peculiarly good position from which to observe merchandising developments and trends. The extent to which the factor's clients utilize such help depends upon their needs. In many cases, however, it is used quite extensively on such problems as developing new products and new lines, securing new sales outlets and new agents, or formulating manufacturing and sales policies.

The Auxiliary Services. The fourth function embraces a number of auxiliary services some of which many factors do not offer. These services are generally covered by clauses supplemental to the regular factoring contract.

Perhaps the chief of these auxiliary services is making advances on consigned merchandise. Formerly this was a common practice among factoring houses but during recent years it has been less prevalent. At the present time such advances are made provided (1) that they may be liquidated seasonally, (2) that, where possible, the consigned merchandise has been made up against approved orders for future delivery, and (3) that the amount of such advances shall not exceed a conservative percentage valuation of the merchandise, such as 30% to 50% on certain types of finished goods, or 70% to 85% on staples, such as grey goods. Instead of having banking lines supplementing the regular factoring service, as is the usual practice, some clients prefer to do their entire financing through the factor by means of advances on merchandise. Most factors, however, discourage the practice.

The "house" facilities comprise a group of auxiliary services also less common than formerly. These include space on the factor's premises for the storage and display of merchandise and maintenance of a selling office. Under such an arrangement the factor generally provides shipping and billing facilities as well. These house services are used most frequently by selling agents who may thereby operate with a minimum overhead since the factor is ordinarily paid by a commission on sales for these services.

Other auxiliary services include the handling of customs and entry of imported goods, as well as assistance to foreign mills in the conduct of their American business. In other cases the factor may attend to or advise its client on tax and insurance matters and corporate organization and partnership problems.

It will be seen, therefore, that, much more than customary even with the commercial bank, there is a high degree of intimacy in the factor's relations with its clients. The extent of this will determine largely the auxiliary services supplied.

The Factor's Compensation. For these various services the factor is compensated by two sources of revenue: the commission on net sales, and the interest charge. The 6% interest charge is used by all factoring houses. Its basis rests in the privilege of customers to anticipate at 6% in the payment of their bills, and the monthly accounting of the factor is based on the assumption that all customers anticipated as of the end of the month.

The commission represents the principal means of compensation. It is calculated on net sales and its amount is determined by various elements governing the profitability of an account, the chief of which are volume of sales, terms of sale, class of trade sold, and average unit of invoice.

As a general rule the larger factoring houses do not take on an account having an expected volume of less than a quarter to half a million dollars, unless it is simply additional business for a selling agent already factored. Neither will they take on a business selling to such an undesirable class of trade that they could not satisfactorily check the credits because of the poor credit risk. Sales made on terms exceeding 90 days are generally discouraged, and sales involving a high number of small shipments and the attendant bookkeeping detail, while not necessarily discouraged, do require a commensurate increase in commission.

The volume of sales and terms of sale, together with the character and standing of the client, are in most cases the principal considerations. The importance of the terms of sale rests in the bearing it has upon the length of time capital is tied up and the period of time on credit risk. Wide variations in the factor's commissions necessarily follow from the varied terms used by the factor's clients. Cotton goods carry terms of from 10 days to 70 days, woolens and worsteds 60 days, in both men's and women's wear, with some extra dating, silks and rayon 10 days end-of-month and 60 days, shoe manufacturers 30 days with some 10 days, paper and pulp manufacturers 30 days. Commissions, consequently, are often broken down on the basis of terms and in turn bracketed on the basis of volume. On 10-day business and volumes running well over $1,000,000, some factoring is done as low as ¾%. For longer terms and smaller volumes the commission may exceed 3%.

Such a commission will cover the assumption of credit risks and the discounting of sales. Practice, however, is not at all uniform in regard to the auxiliary services. In addition to the interest received on merchandise advances, sometimes an additional commission is charged. House services are generally covered by an added commission, although certain ones are often put on an individual cost basis. The other auxiliary services are sometimes rendered under the regular com-

mission, while some houses charge for them individually. In this entire matter of charges for services rendered, we find a considerable variance in the methods used by the different factors.

The Factor's Economic Position

Financial history shows a wide range of companies that have offered in part the service provided by the factor. The principle of securing money on sales before the maturity of the accounts receivable is one of the most ancient in commerce and finance. Commodity loans are an old and common banking practice. Steps to procure protection against credit losses is also an old custom. To the present time, the distinction between the various organizations rendering these services has been largely one of method, degree of specialization, and breadth of service. Today, in addition to the factor, there are three principal agents in the field. They are the commercial bank, the finance company, and the credit insurance company.

The distinction would not always have been clear between the early factor and the early banker before the latter began accepting deposits and finally in the seventeenth century laid the beginnings of modern banking. Commercial banks today loan principally on general credit in contrast to the factor's discounting of receivables. In some cases, however, the bank requires the assignment of accounts receivable as additional security. Commodity loans constitute an important part of the business of some banks just as some factors loan against consigned merchandise. Depending upon the size of the institutions, both the commercial bank and the factor render various auxiliary services for the client. In each case the service is of a confidential nature and the relationship a close one. But there is a very real difference in the manner in which it is actually rendered. The factor's is necessarily more specialized and more comprehensive with its assumption of credit risks and its merchandising tradition. It involves, consequently, a more specialized personnel. Moreover, special office and credit facilities are required to attend to the greater detail in handling credits, collections, and accounting. It will be generally found, however, that the banks and the factor coöperate closely. The latter secures a large part of its money through the commercial bank, and is thereby guaranteeing to the bank the financing of a broad class of companies which the bank is either not prepared or not equipped to finance.

The term "finance company" embraces a wide range of organizations a great number of which do not service the same class of trade as the factor and whose business is an essentially different one from that of the factor. Such companies include those concerning themselves with wholesale and retail automobile financing, the financing of installment selling, or the personal finance business. There is, however, another group which discounts and buys open accounts receivable that has, in the point of service rendered, a great deal in common with factoring. But here again we find a number of very important differences between such finance companies and the factor. In the first place, the factor has a great deal more experience and background. In contrast to the factor's long evolution, we find the first finance company organized in 1905[7] to purchase open

[7] Merrick, Robert G., *The Modern Credit Company*. Baltimore: The Norman, Remington Co., 1922, pp. 5–6. "As far as could be ascertained the first company

accounts on the non-notification basis, the method used by such companies. In the second place, the factor offers an essentially broader service through its auxiliary services, merchandise background, and assumption of credit risks. The finance company does not ordinarily guarantee credits. Thirdly, there is the distinction between the "non-notification" method used by the finance companies and the "notification" method used by the factor. Under the latter method the client's customer is advised of the sale of the receivables by means of the factor's notation on the invoices, and then remits to the factor who handles all collections, accounts receivable ledgers, and bookkeeping. Under the former method the client's customer does not learn of the assignment of the account and remits to the client who acts as a collecting agent in turning over the proceeds to the finance company. This involves a very real difference in the method of conducting the business. By having the invoices payable direct, the factor is in an infinitely stronger position for controlling the receivables and the collections, is able to render a more flexible service for its client and do him more favors, and need not take all the precautionary steps otherwise found necessary, such as frequent examination of client's books, rigid contracts covering the transmission of funds, and fidelity bonds. Finally, under a factoring arrangement, by virtue of the discounting of sales, a cash balance is created with the factor against which the client may draw. The finance company, however, only loans against receivables so that under such an arrangement the client appears as a borrower of funds with a liability appearing on his balance sheet.

Credit insurance companies are, in contrast to factoring houses, also of comparatively recent origin. The first company in this field was organized in 1889.[8] Concerns of this type deal exclusively with credit and, in a limited way, collection problems. While they offer a varied service in their field, it is not as complete as the factor provides, and, because their measure of credit responsibility is usually restricted to agency ratings, it is, in this respect, less flexible than the factor's. The client of a credit insurance company must assume a certain "normal loss," ordinarily he must be a co-insurer for a certain percentage of the loss, and he must check his own credits. The factor's client, on the other hand, is relieved of any credit loss, has his credits checked for him, and has all of the bookkeeping and collection problems taken care of. The fields of the factor and the credit insurance company impinge upon each other to only a limited extent, for the factor is generally interested in providing a far broader service than that of assuming credit risks.

When compared with these three principal financial agents, factoring, it will be seen, has in its merchandising tradition and in its broad and flexible service two distinguishing features.

formed solely to purchase open book accounts was the Mercantile Credit Company of Chicago. This concern was organized in 1905 . . . ."

[8] Ackerman, Saul B. and Neuner, John J., *Credit Insurance*. New York: The Ronald Press Company, 1924, pp. 5–6. "New York, New Jersey, and Louisiana were the first states to enact legislation permitting the incorporation of companies to issue policies, contracts, or bonds of indemnity against losses to those engaged in giving credit. These laws were enacted in 1885 and 1896.

" . . . the United States Credit System Company of New Jersey, organized in 1869, was the first American company in the credit insurance business which operated for any length of time."

We have the discounting service, the assumption of credit risks, a merchandise tradition, and special auxiliary services all combined into one service unique among financial institutions for its breadth and flexibility.

Clientele of the Factor

The clientele using this service does so under a diverse set of conditions and for a variety of reasons. In general, with each client we will find any one of the following conditions obtaining:

1. Where the management, because of inexperience in financial and credit matters or because of a desire to relieve itself of these problems, wishes to concern itself exclusively with production, sales, and distribution problems and places financial and credit matters in the hands of a third party who specializes in them.

2. Where a portion of the sales is made to a clearly distinguishable class of trade with which the management is unfamiliar, is not equipped to pass upon properly for credit purposes, does not wish to incur the overhead necessary to set up such a credit division, and where by factoring such a portion of sales the management has access to the factor's credit facilities for reasonable credit information on the entire sales.

3. Where there is inadequate working capital because of a disproportionately large percentage of invested capital tied up in fixed assets, or where liquid capital has been depleted and where additional cash is needed to meet the demands of pressing creditors, or to discharge burdensome bank lines and avert financial embarrassment.

4. Where the management uses this means of securing additional capital to delay getting permanent capital or to avoid the necessity of securing additional permanent capital and sharing the additional profits with new stockholders or partners.

5. Where, for the sake of flexibility, a minimum of overhead in credit, bookkeeping, and collection facilities is desired.

6. Where invested capital is inadequate for plant capacity and managerial ability, and where the cost of factoring is absorbed by the additional profits from increased sales.

7. Where the management wishes, for the sake of flexibility, simplicity, and economy, to conduct its business on the equivalent of a cash basis.

This clientele embraces organizations of varied character, industries, and size. The larger the factoring house, the larger the clients. Textiles still represent a greater percentage of the factor's volume than any other field, but this percentage is constantly decreasing as factoring concerns turn more and more toward other industries. This the factors were unable to do conveniently until after the separation of the merchandising and financial functions of the old textile commission houses, because in most other industries there was not such an alliance of these two functions in the hands of a third party. Once they were segregated the factor rapidly expanded its business until now we find clients in the shoe, paper and pulp, liquor, pottery, hat, marble wholesale, electrical appliance, leather, and other trades. Steps have been taken toward factoring entire trades through trade associations. The possible fields for the factoring service embrace virtually all products sold on open commercial accounts on terms up to 90 days.

We have seen that the total factoring volume of the reporting houses from 1928 to 1933 showed approximately a 60% increase. While figures for 1934 are not available, it is understood that this growth has continued. There have been a number of contributing elements to this. Within the last few years the working capital position of many manufacturers has been im-

paired by (1) protracted losses, (2) increased costs under NRA, and (3) increased taxes. These elements, together with the frequent necessity of selling to an unfamiliar trade, have made it increasingly difficult and inadvisable for the manufacturers to have much working capital tied up in receivables. Nor were these manufacturers able to comply with their customers' occasional need for special credit accommodations. Selling for cash, of which factoring was the equivalent, was the solution.

The Factor's Future

Of these adverse elements, increased taxes appear to be with us for some time. Increased costs are likely to continue to some degree as the result of the growing labor problem and the carry-over from the NRA. Moreover, the continued unwillingness of the bankers to lend to any but the best risks, and their readiness to loan to the factor who finances such unacceptable risks—all help the factor's business. The entrepreneur of the future, desirous of relief from financial and credit problems, and wishing to enhance the use of his own capital and conserve it against credit losses, is very likely to seek the services of a factor.

Therefore we have in factoring an institution of tradition and long experience, the economic justification of which lies in its increasing volume, profitable operation, and growing acceptance. It renders a common and fundamental service distinguished only by its method of operation and breadth and flexibility. It has the momentum of over a century's evolution and growth. It has demonstrated a facility in adapting itself to changing conditions. Given this momentum and this adaptability, its future rests only with its ability to render at all times its service at a cost commensurate with prevailing competition and business conditions.

EXHIBIT V

FORM OF FACTOR'S CONTRACT

Dear Sirs:

We take pleasure in confirming, by the following letter, the terms and conditions upon which we are to act as sole factor for the entire sales of your merchandise.

1. All sales of such merchandise are to be made by you in your name and all accounts receivable now or hereafter created by such sales are hereby assigned to us in absolute ownership, subject to our obligation to account to you. We are to have the right to institute and maintain actions and proceedings in our name or otherwise to collect such accounts. Invoices and statements to customers are to be sent out in a manner and on forms approved by us, and are to be payable only to us at our office. Shipping or delivery receipts are to be delivered to us covering each day's sales.

2. Sales and deliveries are to be made only with the written approval of our Credit Department. If a customer's credit becomes impaired in our opinion before the actual delivery of the merchandise to him, we have the right to withdraw our approval of any order taken from him. We shall also be entitled to exercise a seller's right of stoppage *in transitu* or *replevin*, and any merchandise so recovered shall be dealt with, as between us, as returned merchandise. We shall not be liable to any person or in any manner for refusing to approve the delivery of merchandise sold or for exercising our rights as set forth herein.

3. On sales thus approved, we will assume any loss by reason of the insolvency of the customer, such assumption of credit risk going into effect upon delivery and acceptance without dispute of the merchandise by the customer. If an unadjusted claim or dispute delays the payment of an account when due, our assumption of the credit risk is cancelled, and the amount thereof may be charged back to you as of the date of original credit.

4. You will report to us all rejections and returns of merchandise and customers' claims immediately upon learning thereof, and will promptly adjust all claims and disputes with customers. Any amount previously credited to you in connection with the sale of merchandise returned or rejected by customers shall be charged back to you as of the date of original credit and such merchandise is hereby transferred and pledged to us, and we are hereby given a lien thereon as security for any sums owing to us. If any such merchandise comes into your posses-

sion, you agree to turn the same over to us unless the amount credited to you by reason of the sale of such merchandise is repaid or otherwise secured to us in a satisfactory manner.

5. We will send you an account of sales within fifteen (15) days after the end of each month and as of the end of the month will discount net sales ("net sales" wherever used herein being gross sales less returns, allowances and cash discounts to customers upon the shortest selling terms) at the rate of six per cent (6%) per annum, adding ten (10) days for collection and slow payment to the actual average due date, and credit you with the net amount thereof. We will remit to you upon request, and shall have the privilege of remitting at any time, the proceeds of sales as they are made, or any amount standing to your credit. In order, however, to protect us against possible returns, claims, allowances, expenses or other items properly chargeable to your account hereunder, we may reserve an amount of past sales which is, in our opinion, reasonably necessary to cover such contingencies.

6. All invoices are to be made out and promptly mailed by you to customers in envelopes bearing return card showing our name and address, so that in the event of non-delivery the envelope will be returned to us, or, if we so request, you will send the original invoices to us for mailing to customers, at your expense. Our title to such accounts will be confirmed by daily assignments thereof to us by you. In assigning your accounts to us, you represent and warrant that each account is based upon an actual sale and delivery of merchandise, that the customer has made himself or itself absolutely liable for the payment of the amount stated in the invoice, that the original invoice bears notice of assignment to us, and that the above provisions regarding the mailing or delivery of invoices have been fulfilled.

7. For our services and our assumption of credit risk as described herein, we shall be entitled to a commission, figured on the net sales and charged to you in account of sales monthly, value the fifteenth of the month of sales, as follows:.....

8. An account current will be rendered to you as of June 30th and December 31st of each year and at other dates if desired. Interest debit and credit at the rate of six per cent (6%) per annum. The accounts as rendered are to be considered correct unless we receive in writing, within thirty (30) days from rendering, any objection thereto together with specifications.

9. Any amounts owing by you to us for merchandise purchased from any concern factored by us or for commissions, interest, etc., are considered as advances against your sales and are chargeable to you in account current at any time at our option.

10. If any checks, drafts, notes, acceptances, other moneyed instruments or cash in payment of any of the accounts receivable assigned to us hereunder should come to you, you will immediately turn them over to us. We, or such persons as we may from time to time designate, shall have the right to endorse all such instruments in your name or otherwise.

11. Should any excise or sales taxes be imposed by State, Federal or Local authorities in respect to sales hereunder or the merchandise affected by such sales, in such form that we are required to withhold or pay the amount of such taxes, you agree to indemnify and hold us harmless in respect to such taxes and that any amount which we may be so required to withhold or pay may be charged to your account.

12. This agreement shall go into effect on the date hereof and is to continue until terminated by either party on ninety (90) days' prior notice in writing. Should either party become insolvent, this contract is terminable by the other at once.

If the foregoing is in accordance with your understanding, will you please sign and return both copies, after which we will sign and return one copy for your files with signatures completed.

Very truly yours,

READ AND AGREED TO:

PLANT LEDGERS AND PLANT ACCOUNTING

BY W. A. HOSMER

THE major problems in accounting for plant have received a new emphasis in recent years because of the regulations of the Securities Exchange Commission, the new policy of the Treasury Department on depreciation under T.D. #4422, and the prevalence of write-downs and revaluations. These developments have raised new issues concerning depreciation and the basis of valuation, issues which involve a reëxamination of the methods used in accounting for plant and in preparing summary figures for publication or for use by the management.

It is becoming increasingly apparent that these problems cannot be considered effectively apart from the detailed records of plant. Plant ledgers are something more than a convenient system for recording detailed facts in readily accessible form; the information contained therein is essential to a realistic analysis of the problems of plant accounting. For that reason plant ledgers will be considered in this article in part in their structural aspects as one portion of accounting systems, but principally as an accounting device which can throw added light on some of the intricate problems of accounting for fixed assets in a rapidly changing economic world.

Problems in Recording the Acquisition and Retirement of Plant Units

There are certain problems in plant accounting which have to be dealt with whether plant ledgers are carried or not. Regardless of the state of the detailed records, it is necessary to determine what the total investment in plant is and the extent to which it has been exhausted by depreciation. Fairly complete detail may simplify the major problems, but they exist regardless of the structure of the plant records.

It is fairly well agreed that the general basis for valuing fixed assets is cost. This is almost universally recognized for the current day-to-day entries. Replacement cost, on the other hand, is essentially an intermittent thing, since it is not feasible to determine a new replacement cost at every closing of the books. Even if a plant is revalued on a replacement cost basis, the natural process of retirement of old units and acquisition of new will soon produce book values of a hybrid nature, partly at replacement and partly at actual cost. Without a full discussion of this matter I shall assume that plant is being carried at cost, representing the investment which has been made in it, but shall discuss a few of the added problems arising from reappraisal.

For most of the assets of most companies the determination of original cost involves few difficulties. Cost of land and buildings means the price paid plus lawyers' fees and any other costs of transfer, and expenditures necessary to put the property in condition for use. If buildings are built under contract, cost is the contract price plus any other charges, such as legal and engineering fees. For machinery the customary basis is the price paid the vendor plus freight and expenses necessary to set the machine up ready for operation. In all these

cases the principal question is whether certain items are to be included, but the lines of principle are drawn in practice with sufficient clarity to obviate most of the difficulties.

In almost all companies there are some plant assets for which it is difficult to determine original cost, and in some companies the proportion of these items is large. One reason is that the original records are not available, especially for old items. Many companies have substantial amounts of assets acquired before the importance of preserving records of cost was fully realized. In such cases it is practically impossible to determine actual original cost, and an appraisal on an original cost basis is the most accurate substitute.

It sometimes happens that a number of units are built on contract and there is a single contract price for the group. The only effective method seems to be to allocate the contract price to the several units on as fair a basis as possible. Otherwise, when some units have been retired, the debit balance standing for the rest will not represent cost.

The situation is more difficult in cases of block purchase of plant assets or the merger of corporations. I am not referring here to consolidated statements, but to the conditions of complete merger. Let us take the purchase of the Columbia Steel Corporation by the United States Steel Corporation in January, 1930, as an example.[1] Assets appraised by United States Steel at $41,375,000 were obtained for 251,771 shares of its common stock. This worked out at $164.34 per share, slightly below the existing market price of the stock. It was evidently a conservative and well advised acquisition of productive capacity on the Pacific Coast. If we assume that these assets were taken up directly on the books of the purchaser, at what figures should they have been entered? In the first place, the cost of the entire group of assets was measured by the cash value of the consideration. Since the consideration in this case was Steel common with an established market, it was possible to judge its cash value with some accuracy, but frequently when a plant is acquired by the issue of securities the cash value of the stock issued is extremely difficult to determine.

After the total cost of the entire group of assets is established, two problems remain: what portion represents the cost of the plant assets as a whole, and what was the cost of each unit of plant? The cost of plant as a whole is ordinarily determined by subtracting an appraised value for the cash, receivables, inventory, and similar assets from the total cost of the entire group. These assets are usually easier to appraise than plant because they are nearer to a realization in cash. But if the cost of the plant is determined by subtraction, the excess in case a high price was paid for the total assets will appear in the cost of plant, and if a low price was paid for the total assets, a low figure will be derived for plant. In the twenties there were many mergers or block purchases at very high figures, and there have been cases since 1930 where plant assets were acquired at very low figures. Although both represent cost to the present holder, the variables involved are frequently greater than those between valuing plant at cost and cost of replacement.

After the cost of the total plant acquired by merger or block purchase

[1] Twenty-eighth Annual Report of the United States Steel Corporation for 1929, pp. 7, 8.

has been determined, it is then necessary to determine the cost of each item. This can only be done on an appraisal basis, the effect of which is to spread the total figure equitably over the several items acquired. Unless this distribution is made, it will be impossible to book retirements, because the amount of the debit standing in the plant account with respect to the items retired will not be known.

The fact of intercorporate transactions in plant raises distinct issues as to the meaning of cost. This is probably the most difficult problem in plant accounting, for cost to the acquiring corporation may be above or below cost to the original holder when the property was first constructed. In terms of plant ledgers the problem is specific: should particular items be set up at the allocated cost to the present holder, or at some other figure? Cost to the present holder has been the basis most commonly used, but when applied to particular units it may give results out of line with what the assets could have been acquired for if bought individually.

A second method not used so frequently is to carry such plant units at cost to the original holder at the time of original installation as far as such costs can be determined. Any depreciation found to have occurred at the time of acquisition by the present holder is set up in the reserve. Any difference between cost to the original holder and allocated cost to the present holder is set up as an intangible, since it is really not plant. If this method had been followed during the boom period, plant accounts would have been more conservatively stated and there would have been less reason for the write-downs which have been so frequent since 1930. Carrying plant at cost to the original holder, and carrying variations between this and cost of acquisition as intangibles, seems on the whole a sounder policy, especially if we consider the long-time effects of the policy.

One rather puzzling problem exists when a large organization buys a competing plant, and immediately liquidates most of it. It is clear that if plant is debited for the purchase price and credited for amounts received in liquidation, a balance will be built up in plant which represents no existing assets and is really of the nature of purchased goodwill. It should, then, be transferred to a goodwill account and not carried as plant.

When assets are acquired by block purchase or merger, the facts and the methods of arriving at the entries for the several items of plant may be preserved in a plant file as described below with suitable references on the cards or ledger sheets, so that audits or other inquiries may be carried on later with a minimum of effort and uncertainty.

The proper booking of retirements is of great importance if the balance standing in the plant account is to reflect the actual condition of the property. The significant thing is that the debits previously standing in the plant account with respect to items retired should be credited out with some accuracy. If old debits are not completely cleared when property is retired, a balance may gradually be built up that is not allocated to any remaining items of plant, and is in fact a ghost of past plant still haunting the ledgers; if the credits are too great the remaining plant is understated. Thus the validity of the remaining balance is dependent among other things upon the care used in booking retirements. If a company allocates its reserve for deprecia-

tion to particular items of plant, it is also important that the reserve be cleared of credits related to items retired.

The balance in the plant accounts is a moving balance, affected by both acquisitions and retirements. This is illustrated in the schedule on fixed assets given in the annual report of the General Electric Company.[2] The final figure for the cost of plant then in service was as much dependent on the total of retirements as on the original debits.

When property is retired, one of three procedures may be followed. If a company has plant ledgers, or detailed records in other form, showing cost or other basis at which units have stood in the plant account, it is relatively simple to credit these amounts out at the time of retirement. If no such records are available, it then becomes necessary to appraise the assets retired as accurately as possible and credit plant on the basis of the appraisal. Any inaccuracy in the appraisals will be reflected in the book value of plant remaining. Another method is to make no entry at all for retirements, but to book all additions to plant as maintenance, a charge against income of the period. If there is no growth and plant is fully kept up, this would give approximately accurate results, but in most situations found in practice it would lead to serious distortion.

What methods are actually used in practice to book retirements? Apparently only 10% or 15% of industrial corporations with plant of over $500,000 use carefully administered plant ledger systems. Many more, possibly as many as 50%, have informal records, such as invoices of machinery purchased, and copies of contracts, from which reasonably accurate data for booking retirements may be obtained. There seems to be a residuum of 30% to 40% of such firms, however, whose plant records are in such order that retirements, if entered at all, must be largely on an appraisal basis. This is a fairly serious matter, for in its effects on plant valuations it probably makes more difference than would a decision as to cost or replacement cost, about which much more has been written. The existence of these facts has been responsible for the activity of the last few years among many corporations in developing and extending their systems for accounting for plant.

There is occasionally a problem as to when property is retired. In the ordinary case, property is retired when it is dismantled. But it may be carried as idle equipment for possible later use, or pending a more favorable opportunity for liquidation. In such cases, if property has in fact been eliminated from the active assets of a corporation, it is sound practice to transfer it to an inactive plant account. The practice of

[2] Forty-first Annual Report, General Electric Company, December 31, 1932, p. 8.

MANUFACTURING PLANTS

From the formation of the General Electric Company in 1892, there had been expended on manufacturing plants to December 31, 1931		$336,825,471.15
Added during 1932		5,747,432.06
		$342,572,903.21
Dismantled, sold, or otherwise disposed of to December 31, 1931	$137,695,738.23	
Dismantled, sold, or otherwise disposed of during 1932	14,149,297.26	151,845,035.49
Cost of present plants		$190,727,867.72

segregating the reserve held against inactive property is not as customary, but it has much to commend it, since if such property carries a heavy enough reserve, actual retirement has little effect on the net book value of plant.

Making proper entries to record the acquisition and retirement of plant units is a complex process, dealing with transactions many of which are intricate and all of which involve a long-time cycle between the acquisition and retirement of particular units. It is not a simple mechanical matter. Accurate entries cannot be made without detailed records of some sort, and the accuracy of the final figures for plant as displayed on the balance sheet is dependent on the care and thoroughness with which the transactions summarized in those final figures have been handled. It is fruitless to define principles with great exactness if the techniques for applying those principles are not in good order. Plant ledgers or some valid detailed substitute seem to be essential to conservative accounting for plant.

It is desirable to have the records in such form that the data necessary to book retirements can be assembled without undue labor. The total debit standing in the books, both for original purchase or construction and for later improvement or addition, if capitalized, must be known, and if there has been a reappraisal, the amount applicable to the item retired must be known. If a plant ledger is not carried, it is often extremely difficult to obtain these figures for items acquired possibly 30 years ago. In addition, if the reserve is handled by items, the amount allocated to the unit retired should be known and should appear on the plant ledger card. Then if a work order or similar document shows the cost of dismantling and net salvage, if any, proper entries can be made with confidence. If any parts of the item retired are put in stores pending use or sale, some book value would have to be ascribed to such parts.

Heretofore we have assumed a cost basis, but there are one or two additional problems which appear if there has been a revaluation at replacement cost or otherwise. If the revaluation has been on an over-all basis, it is necessary to break it down by items so that the balance representing these items may be cleared at retirement. It is obvious that if a plant has been reappraised upward and items retired are cleared at cost, or at a figure not reflecting the full amount of the increase, a balance will be built up not related to property still in use. As an aid to the solution of this problem and matters of depreciation, it is advisable to break down reappraisals and carry the new book values into the detailed plant records. If necessary the records can be arranged to carry both cost and appraisal figures.

In order to book retirements accurately it is, of course, not essential that formal plant ledgers be carried. A work order system, or other similar device, if carefully administered and kept in good order, can furnish the information needed for accurate booking of retirements. The significant fact is that information as to the debit balance representing a particular item must be available in some way if that item is to be cleared with accuracy at retirement.

Structural Features

Structurally, detailed records of plant are similar to a perpetual inventory of merchandise except in two significant ways. The turnover of merchandise is very much more rapid, resulting in many more entries each year with re-

spect to each item. This affects the relative cost of the two types of records, and also the nature of the technical systems appropriate to each. Furthermore the information about plant is needed for many years, whereas there is little use of detailed merchandise records after the period to which they refer. Except for this matter of timing, plant records are very similar to ordinary perpetual inventories.

A plant ledger system should provide for a physical record of property held. Each card or ledger sheet ordinarily carries a brief description of the machine or other item, with specifications, the model number and size, and other significant information. There is usually space for the machine number, the department number, and notation of the location. This type of information is important, for a complete set of such cards constitutes a physical inventory of plant assets.

For many items the short description which can be put on the ledger card may be sufficient but for others a properly keyed file may be useful as a supplement. In such a file—arranged by machine numbers—blue prints, detailed specifications, pages from the builder's catalogue, or copies of contracts may be preserved. Photographs of buildings or important machines may be added at relatively little cost. When a machine has been rebuilt, or a complex transaction has occurred affecting an item, it may be advisable to dictate a summary sufficient to make the matter clear to anyone who needs the information later. In all such matters it is necessary to bear in mind that entries may have to be made affecting plant items after all the present members of the accounting department have retired, and when facts which are now a matter of common knowledge have long since been forgotten. When such a file is kept in the plant to which it refers, it is obvious that it should be protected from fire. If accumulated currently, the cost of such a supplementary plant file is not great and may be saved in a single insurance adjustment.

As already mentioned, the department in which a machine is used and its physical location are usually entered on the ledger card, and of course all changes in department or location should be noted. It is a great advantage if the machine number by which a particular machine is identified in the ledger is attached physically, by tag or otherwise, to the machine to which it refers. Ordinarily the machine number is also used as the number of the ledger account referring to that particular machine. Every ledger entry can then be checked back against the physical property without undue effort. It also facilitates the practice, which seems to be customary in the best installations, of taking a physical inventory of plant every two or three years, possibly by checking one-third of the items each year. Neither a merchandise nor a plant inventory can be relied on unless it is checked occasionally against the physical assets.

It does not seem to be customary to distribute maintenance expenditures by machines and enter them on the ledger cards. Since maintenance is not a part of the controlled balances, it may be entered as a statistical figure, possibly on the back of the card. In decisions affecting types of equipment to be purchased, or whether certain machines should be replaced, it is often highly desirable to know the maintenance characteristics of each. The reason this information is not preserved is apparently the cost. As a result of the slow turnover of plant,

transactions involving acquisitions, improvements, or retirements may require only 200 to 300 postings a year per 1,000 ledger cards, whereas the entry of maintenance might require 2,000 or more postings. If a company has Hollerith or Powers equipment, the maintenance work orders could be preserved till the end of the year and then run for a total by machine numbers, so that a single entry might be made to each ledger card giving the total maintenance on that machine for a year. Or the work orders might be preserved and a total by machine numbers be taken manually once a year without excessive cost. In any event the question of whether maintenance should be included in the detailed records depends upon the usefulness of the information and the cost of preserving it.

The structure of the controlling accounts is related to the classification of plant items desired, and is very flexible. Land, buildings, and building equipment may each have a controlling account in the general ledger and a group of cards for the items, since the number of items in each of these classes is small. For machinery there may be a single controlling account in the general ledger with the detailed cards divided by departments. A summary card may be used to carry the combined balances of all items in each department and thus serve as a sub-controlling account, the balances of the several departmental summary cards being controlled by the general ledger account "Machinery." By variations of this or similar techniques a classification can be produced in the plant ledger which will make it most useful in the cost and general financial records.[3]

When depreciation is broken down by items it introduces an element of dual control. The depreciation reserve on the individual card is a separate account, subject to the control of the depreciation reserve account in the general ledger. Probably the breakdown of the controlling accounts for the reserve should parallel that for the assets.

The question whether depreciation should be broken down by items seems to depend on policies in setting depreciation and in booking retirements. If at the time of retirement only the amount of depreciation previously charged on that machine is to be debited to the reserve, there must be some method of determining the amount. If the whole difference between cost and net salvage is charged to the reserve, the amount accumulated on a particular machine is not so important. When a single percentage is used uniformly year after year, it is possible to determine the accumulated depreciation by multiplying the rate per year by the years of use. The years of use can be determined from the dates on the ledger card and space can be readily provided for the depreciation rate. Any irregularity in rates as between years makes it desirable to enter depreciation on the cards so that the reserve and net book value by items will always be available.

This matter of having accurate data on depreciation already charged is likely to become more important as the new policy of the Treasury De-

[3] Current practice in the structure of plant records and the use of forms are considered in the following articles: Sanders, T. H., "Accounting for Depreciation," National Association of Cost Accountants, *Year Book*, 1925, pp. 51–80; Walsh, M. B., "Plant Equipment Forms," *Bulletin of the National Association of Cost Accountants*, October 15, 1935, pp. 175–183.

partment develops. Another practice useful in the same connection is that of preserving the ledger cards of retired plant items as useful evidence in determining depreciation rates.

In determining whether it is advisable to install plant ledgers in a specific instance, it is necessary to consider what it will cost to install the system and what it will cost per year to operate it after it is in running order. It is impossible to obtain exact data, but the experience of companies which have plant ledgers indicates that limits can be set up within which the cost should fall. It is obvious that these costs depend in part on the nature of the property and in part on the structure of the records.

Most installations seem to show about 1,000 accounts in the plant ledgers for each $1,000,000 of gross plant. This varies with the type and size of equipment, and with the extent to which the system is used to account for tools, dies, and other units with a small book value. In a paper mill in which a single account is carried for each paper machine, the number of accounts per $1,000,000 of property ran very much less than 1,000. An installation in an industry using many small units has 12,000 cards for approximately $10,000,000 of gross plant.

There are ordinarily about 200 postings per 1,000 ledger accounts to record the acquisition of new property, improvements, and retirements. This means that each account requires a posting which alters the book value of the asset on the average of about once every five years. This, of course, varies with the rapidity with which changes are made in plant and in the extent to which short-lived assets, such as tools and dies, are included on the plant ledger. If depreciation is broken down and recorded by items, this requires from 1,000 to 1,200 postings each year per 1,000 units. This assumes that there will be one entry each year in each account for depreciation, and that there will be a few additional entries for adjustments, and for the retirement of property. If maintenance is entered with respect to each item, this requires typically from 1,000 to 2,000 postings per year. The frequency of such entries depends upon the characteristics of the equipment, that is, the extent to which maintenance is actually done, and also upon the method used. If the maintenance work orders are preserved until the end of the year and then a total is taken by machine numbers, the number of entries to record maintenance should not run over 1,000 per year per 1,000 accounts.

The cost of installing a system of plant ledgers depends in part on the number of items, that is, upon the average book value per item, and in part upon the way in which the plant records have been previously carried. In a number of cases the cost of installation has run from $1,000 to $3,000 per $1,000,000 of gross property. In some instances plant ledgers have been set up by the accounting and engineering staff of the company itself during slack seasons at costs as low as $300 per $1,000,000, whereas one case involving some 14,000 accounts and $9,000,000 of property cost nearly $5,000 per $1,000,000 to install, or a total of $45,000. In this case the previous plant records were very deficient, and it was extremely difficult to obtain information from which to set up a plant ledger.

The cost of operating plant ledgers after they are installed and in running order appears to vary widely, the estimates of those using such systems

being from $300 to $1,000 per year per $1,000,000 of property. There is some tendency for the cost to decline with increased amounts of property handled. One public utility carries fairly complete records on $250,000,000 of gross plant for about $50,000 a year, or at the rate of $200 per year per $1,000,000.

These figures are based on estimates made by accountants in charge of the operation of plant ledger systems. They are only rough approximations but should suffice to set limits within which the cost of installing and operating such a system should fall. More accurate figures could be obtained if it were customary to apply cost accounting to the cost of operating accounting systems. Some of the higher estimates of cost apparently are the result of systems which are more complex than they need to be. Even if it does cost from $300 to $1,000 per year per $1,000,000 of property to operate plant ledgers, this is not an additional cost because it obviously costs something to account for plant under any other method. It has proved impossible to obtain definite estimates of the cost under other methods, but it seems probable that in some cases the costs of less formal methods are as great as those of plant ledgers.

Applications of Data in Plant Ledgers

It is a peculiarity of this matter of plant accounting that we have to establish present systems and records in view of the use which may be made of them many years in the future. In discussing the types of records which are advisable it is necessary to keep this matter of probable future developments in mind.

Income Tax Accounting. One of the important current developments is the new depreciation policy of the Treasury Department. When the present revenue act was in Congress, a proposal was made to reduce all depreciation deductions by an arbitrary 25%. Secretary Morgenthau suggested that the same result could be achieved by regulations and T.D. #4422 was the result. It is fairly clear that T.D. #4422 and the policy expressed therein were intended to have the effect of reducing deductions for depreciation on corporate returns, and thereby bringing about by indirection an increase in the revenue from income taxes.

A quotation from an article by Maurice Peloubet on depreciation under the revenue act of 1934 indicates the magnitude of the reduction intended.

> Recognizing, however, that Congress demanded the raising of additional revenue, the Treasury Department promised, by means of changes in administration, without any change in the law, to bring in the additional $85,000,000 of revenue demanded by the Committee on Ways and Means. This is a sufficiently impressive sum, but when we think that, at a tax rate of 13¾%, this means a reduction in allowances for depreciation and obsolescence to taxpaying corporations of about $618,000,000, we get some idea of the magnitude of the job which the Treasury Department chose for itself.

The latest year for which published statistics of income are available is the year 1931 and that year may not be unfair for comparison with 1934. We know that in general the industrial facilities of the country have not been largely increased since that time. The year 1931, while a year of declining profits, was better than 1932 or possibly 1933, and may approximate 1934 better than either of those two later years. A comparison of the treasury proposals with 1931 figures, therefore, should give us a reasonable basis for judging their probable effects.

The proposed or hoped-for reduction in depreciation allowed to tax-paying corporations of $618,000,000 amounts to 36% of the total deduction for depreciation taken by tax-paying corporations in the year 1931 ($1,721,295,000) and amounts to about 13% of the total income of all tax-paying corporations for that year ($4,642,204,000).[4]

A quotation from T.D. #4422 is significant in our present inquiry.

> . . . The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed.[5]

The fact that the burden of proof is thrown on the taxpayer is nothing new, because the burden always has been on him, but it probably will be new in the manner of application. In applying the general policy of reducing depreciation deductions, the department will probably examine returns in more detail, especially where the reserve or the depreciation claimed seems high, or substantial additional revenue would be obtained by a reduction, and in examining returns the department will rely less on blanket percentages and will require more detailed schedules.

The best position for the taxpayer to be in regarding depreciation under the present administration is to have a detailed record of each item included in his accounts for buildings, machinery and equipment or other depreciable assets showing cost or basis, date acquired, expected life, depreciation written off and all other pertinent data. A good form for such a record is that given on page 97 of Saliers on *Depreciation* —Principles and Applications—1922 edition. The further the taxpayer departs from these conditions the more difficulty he may have in establishing his position. It is much easier to show the probable life of an individual machine than that of a group and it is practically impossible to prove a loss on dismantlement, except where individual records are kept.[6]

This matter of the unrecovered cost of property dismantled will be of particular importance in the next five years. Obsolescence and the pressure of income and property taxes will probably make it desirable to dismantle large volumes of physical property. If this property is sold, the loss which can be taken as a deduction is limited to $2,000 per year, but if the property is actually broken up this limit does not apply. The regulations are not clear on this point at present, but several accountants with extensive practice in tax cases have concurred in the opinion expressed in the quotation above that it will probably be impossible to deduct unrecovered cost unless cost and depreciation have both been recorded by individual items. If this is so, it seems to make detailed plant records almost imperative, if full advantage is to be taken of available deductions in determining taxes.

The Securities and Exchange Commission. The present regulations of the Securities and Exchange Commission

[4] Peloubet, Maurice E., "Depreciation under the Revenue Act of 1934," *Journal of Accountancy*, September, 1934, pp. 173–174.

[5] T. D. #4422—Treasury Decisions, March 8, 1934; Vol. 65, No. 10; Internal Revenue, p. 75.

[6] Peloubet, Maurice E., *op. cit.*, pp. 184–185.

do not require anything at all drastic in connection with the plant accounts. The provisions for permanent registration of securities under Form 10 are included in Schedules II, III, and VIII.[7] The balances in the property accounts at the beginning of the year, as carried on the books of the company, are to be given, with additions during the year at cost, retirements or sales and other changes, and balances at the end of the period. Similarly the balances in reserves for depreciation, depletion, and amortization are called for, with additions and charges during the period, and balances at the end. Where so carried in the books, the reserves are to be classified to correspond with the classification of property. In Schedule VIII the amount of maintenance and repairs and of depreciation, depletion, and amortization, or charges in lieu thereof, are to be given, subdivided to show separately amounts charged to costs, to profit and loss, and to other accounts.

These schedules are reasonable in that the information they call for ordinarily is available in the books of any well-managed corporation, and they are flexible in permitting the adaptation of the form of report to the practices of individual companies as long as the general principle of full disclosure is adhered to. There seems to be no valid objection to the disclosure of this information, although the record of transactions involving plant will be more complete than it has customarily been in the published reports of corporations.

It would have caused endless confusion if the commission had required that plant accounts for prior years be checked over to bring them into accordance with some prescribed formula. It is important to observe that the detailed information on the schedules begins with the opening balances for the first year for which Form 10 is submitted. Since Form 10 is required for the most recent fiscal year ending on or after December 31, 1934, this means that no detailed figures were called for prior to December 31, 1933. The commission did ask for a statement on the basis of the amounts shown as opening balances, and a description of significant changes by appraisal or otherwise in the ten years preceding 1934.

The information called for on Schedules II and III which is most directly related to plant ledgers is that concerning retirements. Here we have the same problem discussed above. If a corporation has detailed plant records it can book retirements at recorded cost, or if they have been revalued, at other appropriate figures which can be explained. If detailed figures are not available, and retirements are booked at an appraised value at the time of retirement, the basis for such retirements would presumably have to be explained.

Retirements of plant will be, of course, only one item on the reports filed with the commission, and in many instances it will not be of primary importance. But in other cases, such as a determination of the fixed assets securing a bond issue, interested persons may examine the figures on Schedules II and III with great care. Since the liabilities for anything which might be construed as a misstatement of material fact are so serious, a company would seem to be in a safer position if the facts reported on these schedules, especially retirements, were based on fairly comprehensive detailed records.

Public Utilities. In the public utility field three commissions—New York,

[7] Securities and Exchange Commission, *Instruction Book for Form 10 for Corporations*, Edition of March, 1935, pp. 24, 26.

New Hampshire, and Wisconsin—have recently required continuing property records, meaning thereby plant ledgers.[8] The task of installing these systems has proved to be laborious and expensive.

The method of plant accounting in use in most states other than New York, New Hampshire, and Wisconsin is the work order system. The construction of new plant is authorized by a work order which gives specifications and full details on the plant to be constructed. On completion, costs are entered on a copy of the work order and it is filed chronologically. Often several items are entered on a single work order.

This system was formally required in Massachusetts in 1921 and was used by many companies prior to that time. It was introduced in other states at about the same time. If carefully administered, accurate plant records may be kept by this system, but at best it is awkward and does not preserve the requisite information in readily accessible form. Records of different items are not classified by location or kind, and it is extremely difficult to check a work order system by a physical inventory of plant. The inherent complexity of utility plant has so taxed the capacity of the older work order system that utility executives may prefer the new continuing property records when the difficulties incident to their installation have been overcome.

The considerations which have led commissions to require plant ledgers in utility practice are similar to those which have already been discussed with respect to industrial practice. A complete system includes a perpetual inventory of the physical items of plant, which is the starting point of a valuation, whether by appraisal or otherwise. If identifying numbers are used on the items of property, the book record can be checked by a physical inventory, so that all parts of the debit standing in the plant account can be related to specific physical property. A full record of the details involved in the book value of each item should appear upon its ledger card, facilitating a checking of book values, item by item, which is impossible when general figures alone are available. As plant records have been kept in the past it has been practically impossible for the accountants of the commissions to audit these records effectively and to control the excesses of a few companies which have reacted so disastrously on the industry.

Evidently the commissions have also felt that properly classified detailed records, which can be checked against the physical property, will prevent the inflation of plant accounts, or at least reduce a tendency to overstatement. The auditors for the receivers of Middle West Utilities discovered $18,668,443.05[9] still standing in the plant accounts which represented plant already dismantled or sold. The physical inventory feature of plant ledgers would furnish a desirable check on the completeness with which old debits have been cleared from the books. Second, if each of a large group of gas companies reported the book value per foot of four-inch welded steel mains in service, comparison would soon show any inflation in the case of one or two companies. The new technique of continuing property

[8] Public Service Commission State of New York, Uniform System of Accounts for Electric Corporations, Effective January 1, 1934, p. 23; State of New Hampshire Public Service Commission, Uniform Classification of Accounts for Electric Utilities, Effective January 1, 1935, p. 30; Wisconsin Public Service Commission, Uniform Classification of Accounts for Electric Utilities, Class A, 1932. Fixed Capital Accounts, General Instructions and Definitions, Section 3.

[9] Report of Edward N. Hurley, Charles A. McCulloch, Receivers Middle West Utilities Company, June, 1933, p. 74.

records lends itself readily to the effective use of comparison as a tool of regulation. It is entirely possible that these new records may justify plant valuations which have been questioned by the commissions.

The application of plant ledgers in the utility industry is a matter of tremendous complexity. Once installed they are likely to prove highly useful both to the companies and to the regulatory commissions. If they work well in the states which have adopted them, they probably will become standard practice in other states within a relatively few years.

Plant Ledgers and Executive Control

Are detailed plant records worth their cost as part of the machinery of administration of industrial and utility enterprises? Accounting techniques and accounting data should be judged by their effectiveness in providing a factual basis for executive decisions within the enterprise, and for the decisions of creditors and investors from the outside. It is on this basis that the desirability of plant ledgers should be judged.

There are relatively few executive decisions which involve data from detailed plant records but those which do are likely to be of importance, such as the determination of depreciation, with its resultant effect on net income, and decisions as to the replacement of particular items of equipment.

Adequate plant records are valuable in some of those decisions which involve the addition of new lines or the elimination of old—the whole problem of adapting a relatively fixed plant investment to the changing profit possibilities brought about by the constant shift in processes and methods and the competition of new products.

The central difficulty when plant ledgers are not used lies in handling retirements. We are likely to have a great deal of physical property dismantled and broken up in the next five years, partly to escape taxation, and in part because of increased obsolescence. A critical point in obsolescence occurs when the costs of production with new equipment carrying full overhead are less than the costs with old equipment carrying little or no overhead. Apparently a number of industries have about reached this point. When they do, and when the fact is fully realized, older equipment will be eliminated and broken up in large volumes. This is likely to occur in the next five years, and, if so, will emphasize the problem of accounting for retirements in order to preserve sound figures for the cost of fixed assets retained.

It has happened occasionally in the past in cost accounting and financial accounting that detailed records have been built up which were too complex and expensive to operate, and such systems have sometimes been eliminated. This has delayed, but it has not prevented, the development of soundly conceived techniques. In considering whether to install plant ledger systems accountants should guard against needless complexity and expense, because the information needed can be preserved at an expense which is moderate in comparison with the assistance such systems can render in the solution of executive problems. The present activity in installing plant records reflects the fact that for many companies the balance of advantage favors an extension of detailed records in this area.

EXECUTIVE COMPENSATION COMPARED WITH EARNINGS

BY JOHN C. BAKER

THE question of executive salaries or compensation has been of rapidly deepening interest ever since the publicly owned corporation became an outstanding factor in our business life. Discussion of the relationship between compensation and corporation earnings, however, has for the most part been either purely theoretical or an isolated consideration of a specific man on a specific job. This has been due entirely to the reluctance of companies to give out definite information concerning executive compensation, but public demand for such information has been growing, and it was not surprising that the 73rd Congress (1st session) in Senate Resolution #75 empowered the Federal Trade Commission to make an investigation. As a result, a revelation of complete salary data was forced, and we now have valuable material available for the years 1928 to 1933 on this important subject. The material must be examined carefully and dispassionately; otherwise it will not fulfill its real function—that of bringing about more equitable arrangements for all parties concerned, and of indicating sound corporate policies toward the problems of executive compensation.

The two groups most deeply concerned in the question of corporate compensation are the executives themselves and the stockholders. The stockholders' chief interest naturally is in net earnings. The public, represented by the government, is also definitely concerned because of the possible effect of compensation policies on the price of products to consumers. On many occasions the courts have been forced to pass on the question of the fairness of compensation. Because of lack of information, their decisions have been narrow in scope; it will be of interest to observe how future legal decisions may be affected by the revelation of detailed figures on compensation and earnings.

The following study is written to show what the available figures reveal on the relationship between earnings and executive compensation.[1] Both stockholders and the public have been concerned with two questions: (1) what percentage of earnings is paid in total executive compensation; and (2) is there a relationship between this percentage and company earnings over a period of years?

This study will not attempt to answer the questions: are corporation officials paid too much or too little, or are large salaries justified? Neither will it try to lay down general rules in an abstract way as to what executive compensation should be, nor generalize on what drives an executive to his best efforts, whether it be high compensation, pride, desire for power, or love of achievement. It will definitely attempt, however, to show the percentage of earnings paid by the companies examined for one- and for five-year periods, which companies fall in a low and which in a high

[1] Andrew R. Towl, second-year student in the Harvard Graduate School of Business Administration, assisted the author with the statistical work.

compensation class, and what relationship, if any, exists between earnings and compensation of the companies in these two classes. The writer believes that high and low compensation cannot be tied to a definite salary figure (for example, $50,000 or $300,000 annually); it must be related to earnings and compared with the compensation paid by other corporations in the group under consideration. On this basis high executive compensation[2] means the payment of a larger percentage of earnings, and low executive compensation means the payment of a smaller percentage than the average paid by the other companies examined. The methods used to indicate whether or not a company falls into the high or the low compensation group will be described later.

Earnings and Total Compensation of Officers

In order to answer the questions raised, clearly defined and understood earnings and total compensation figures are needed. There are two definite requirements for the earnings figure. It must be the fund out of which total compensation is paid, and it must be a comparable figure among all the companies examined. After a detailed examination of the various companies in the sample on which this study is based, it was decided to define earnings as the net income of a company prior to the payment of executive compensation and bond interest.[3] Depreciation charges also were carefully examined because of their possible effect on earnings and because they can be adjusted at the discretion of certain officers. The changes in depreciation charges by this group of companies, however, varied so slightly (a 4½% decline from 1929 to 1932) that it was decided not to adjust earnings for depreciation.[4]

Total compensation fortunately was defined by the Federal Trade Commission in requesting salary information as the "salaries and all compensation, direct and indirect, including that from subsidiary and affiliated companies, paid to executive officers and directors each year from 1928 to 1933 inclusive." For example, in 1929 the United States Steel Corporation paid $1,156,960 total compensation to 13 officers (the chairmen of the Board and the Finance Committee, the president, four vice-presidents, treasurer, general and special counsels, general solicitor, comptroller, secretary) and 10 directors.

Companies Selected and Periods Studied

The 100 companies selected for the investigation are almost entirely manufacturing companies—a cross section of the 450 industrial companies which reported the data sought by the Senate Resolution. This same group was used by Professor W. L. Crum and the author some months ago in another study of executive compensation.[5]

[2] It should be noted that high executive compensation need not necessarily be synonymous with the popular concept of "large salaries," although it may be.

[3] Thus company earnings, for example, those of the United States Steel Corporation in 1929, were secured as follows:

Balance available for dividends*		$197,592,000
Plus: Interest charges	$14,945,000	
Total executive compensation	1,157,000	16,102,000
Earnings		$213,694,000

* The "Balance available for dividends" of most companies was secured from *Moody's Manual of Industrials*.

[4] The figure "after depreciation" is of direct concern to stockholders, and its use does not materially change the compensation groups or the consequent conclusions drawn in the study. If the earnings figures used had been before depreciation charges, the conclusions reached would have been further accentuated.

[5] "Compensation of Corporation Executives—The 1928–1932 Record," XIII HARVARD BUSINESS REVIEW 3, Spring, 1935.

TABLE I

EARNINGS,* COMPENSATION, AND ASSETS OF 100 COMPANIES IN 1929 RANKED ACCORDING TO PERCENTAGE OF EARNINGS PAID IN COMPENSATION

Low Compensation Group

	Percentage of Compensation to Earnings 1929	*Earnings (Unit $1,000,000)*	*Total Compensation (Unit $1,000)*	*Assets 1929 (Unit $1,000,000)*	*Percentage of Compensation to Earnings 1928–32 Average*
†United States Steel Corp.	0.54	213.7	1,157	2,386	1.15
Standard Oil Co. of Calif.	1.25	47.2	591	605	1.91
Youngstown Sheet & Tube Co.	1.62	25.6	413	236	6.80
†Standard Oil Co. of N. J.	1.70	132.2	2,237	1,767	2.65
Atlantic Refining Co.	1.93	18.5	356	167	2.73
†duPont de Nemours & Co.	2.17	79.0	1,707	542	2.22
†Nash Motors Co.	2.49	18.5	461	64	3.99
†Tide Water Associated Oil Co.	2.64	17.3	457	251	3.19
†American Smelting & Refining Co.	2.67	24.4	652	241	4.93
United Fruit Co.	2.70	18.3	493	226	3.53
General Baking Co.	2.74	7.4	204	41	3.34
†Westinghouse Elec. & Mfg. Co.	2.81	28.1	789	254	6.80
†Packard Motor Car Co.	2.90	25.9	752	81	4.73
Granite City Steel Co.	3.04	1.7	53	11	5.68
B. F. Goodrich Co.	3.10	10.7	333	164	31.00
†Harbison-Walker Refractories Co.	3.13	5.4	170	53	5.32
†Inland Steel Co.	3.18	13.5	429	103	5.11
†Lambert Co.	3.59	7.3	261	7	5.10
Firestone Tire & Rubber Co.	3.66	10.2	372	162	4.44
†Allis-Chalmers Mfg. Co.	3.69	5.3	197	73	6.63
†Mid-Continent Petroleum Corp.	3.69	8.0	294	86	16.80
Cannon Mills Co.	3.75	4.3	162	38	5.76
†United States Gypsum Co.	3.79	5.3	201	64	4.27
†International Cement Corp.	3.82	6.1	232	56	5.24
†Radio Corp. of America	3.93	16.5	648	159	4.61
Hudson Motor Car Co.	4.07	12.1	493	69	11.80
†Borden Co.	4.09	22.5	922	175	5.26
†General Foods Corp.	4.14	20.3	839	71	3.80
†Standard Brands, Inc.	4.40	19.2	845	77	4.70
Ward Baking Corp.	4.43	3.6	159	45	4.28
Grigsby-Grunow Co.	4.46	2.0	89	24	353.00
Chickasha Cotton Oil Co.	4.65	1.1	50	13	9.43
†Deere & Co.	4.76	16.6	792	85	8.06
†General Railway Signal Co.	5.10	3.3	168	22	7.56
†Hercules Motors Corp.	5.17	1.2	62	4	9.46
†A. M. Byers Co.	5.23	2.1	109	28	11.60
†Liggett & Myers Tobacco Co.	5.32	25.0	1,334	150	4.32
†International Harvester Co.	5.34	39.4	2,099	384	6.64
International Paper & Power Co.	5.43	7.8	425	283	9.65
†Loose-Wiles Biscuit Co.	5.65	3.0	169	29	6.52
†Commercial Solvents Corp.	5.83	3.9	227	13	7.04
†Mack Trucks, Inc.	5.88	7.4	435	69	11.80
†J. I. Case Plow Wks., Inc.	5.94	4.1	243	56	11.70
†Air Reduction Co., Inc.	5.96	6.4	378	31	8.38
†Corn Products Refining Co.	5.99	17.5	1,045	127	7.15
†American Tobacco Co.	6.14	32.2	1,974	265	6.42
†Colorado Fuel and Iron Co.	6.14	4.2	260	80	17.80
†International Bus. Machines Corp.	6.32	7.3	462	40	6.95
†Reynolds Metals Co.	6.33	3.8	242	11	7.28
Eureka Vacuum Cleaner Co.	6.55	1.4	89	7	45.30

* Percentage of compensation to earnings may vary from the ratios of dollar figures as listed, because the latter are rounded to nearest thousand or million.

† Companies paying compensation in addition to cash salaries in 1929 (so-called bonus companies). All companies in the bonus group, however, did not have definite bonus plans.

TABLE I (*Continued*)

EARNINGS,* COMPENSATION, AND ASSETS OF 100 COMPANIES IN 1929 RANKED ACCORDING TO PERCENTAGE OF EARNINGS PAID IN COMPENSATION

High Compensation Group

	Percentage of Compensation to Earnings 1929	*Earnings (Unit $1,000,000)*	*Total Compensation (Unit $1,000)*	*Assets 1929 (Unit $1,000,000)*	*Percentage of Compensation to Earnings 1928-32 Average*
†American Locomotive Co.	6.64	7.3	486	106	24.40
†Bethlehem Steel Corp.	6.92	57.4	3,973	802	9.20
†Colgate-Palmolive-Peet Co.	7.08	9.8	694	64	8.18
Kimberly-Clark Corp.	7.24	4.5	325	49	11.30
†U. S. Rubber Co.	7.30	7.0	511	249	d
American Encaustic Tiling Co.	7.33	.8	55	5	61.30
Bulova Watch Co. Inc.	7.34	2.0	150	7	10.20
†Otis Elevator Co.	7.42	9.0	670	54	8.58
Western Dairy Products Co.	7.50	1.9	142	22	10.10
†Thatcher Mfg. Co.	7.53	1.0	75	6	8.40
†Bayuk Cigars, Inc.	7.74	1.6	126	16	21.30
†Pittsburgh Steel Co.	7.99	2.6	207	61	23.60
†Mathieson Alkali Works (Inc.)	8.00	2.5	202	22	9.77
†Julius Kayser & Co.	8.14	3.2	260	25	14.10
†Allegheny Steel Co.	8.55	3.6	309	31	16.50
†Weston Electrical Instrument Co., Ltd.	8.92	1.1	95	5	16.90
Crosley Radio Corp.	9.04	1.2	108	7	9.19
†Brown Shoe Co., Inc.	9.13	1.9	174	20	9.02
Lee Rubber & Tire Corp.	9.22	.7	61	11	293.00
A. G. Spalding & Bros.	9.70	2.5	243	23	29.10
†Vulcan Detinning Co.	10.00	.7	69	7	16.10
L. S. Starret Co.	10.70	.8	91	5	21.60
†American Steel Foundries	10.80	5.8	625	59	18.40
†Clark Equipment Co.	10.90	1.5	164	12	23.60
Pillsbury Flour Mills, Inc.	10.95	2.5	275	33	11.50
†Chicago Pneumatic Tool Co.	11.00	2.0	225	22	19.10
Baldwin Locomotive Wks.	11.20	3.5	391	99	42.50
†Real Silk Hosiery Mills, Inc.	11.69	2.3	273	13	15.70
†Federal Motor Truck Co.	12.40	.6	76	8	53.00
†Mohawk Carpet Mills, Inc.	12.40	2.1	256	26	31.10
United Dyewood Corp.	12.90	.7	86	23	20.10
†American Brake Shoe & Foundry Co.	13.30	3.7	495	33	15.90
Archer-Daniels-Midland Co.	14.60	1.7	248	24	14.90
†Pet Milk Co.	16.11	.9	147	16	16.90
Austin, Nichols & Co., Inc.	16.20	.3	53	3	d
Manhattan Shirt Co.	16.30	1.2	192	15	34.60
Intertype Corp.	16.40	1.0	160	8	23.40
†Trico Products Corp.	17.10	2.7	462	6	13.50
†Devoe & Raynolds Co., Inc.	18.85	1.3	252	14	27.60
†National Distillers Products Corp.	19.40	.9	180	28	15.70
†Young Spring & Wire Corp.	19.50	1.6	304	10	11.90
Phillips-Jones Corp.	20.60	.6	133	10	89.00
Snider Packing Corp.	22.80	.4	88	9	d
Adolph Gobel, Inc.	23.00	.3	80	12	19.00
Superior Steel Corp.	25.60	.3	67	7	d
American-LaFrance & Foamite Corp.	29.40	.4	129	13	d
Century Ribbon Mills, Inc.	122.50	.1	148	6	160.50
American Woolen Co.	d	d2.8	437	114	d
Gabriel Co.	d	d .3	43	2	d
Norwalk Tire & Rubber Co.	d	d .4	34	2	d

* Percentage of compensation to earnings may vary from the ratios of dollar figures as listed, because the latter are rounded to nearest thousand or million.

† Companies paying compensation in addition to cash salaries in 1929 (so-called bonus companies). All companies in the bonus group, however, did not have definite bonus plans.

d Company reported a deficit before executive compensation, interest, and dividends.

The five-year period between 1928 and 1932 was chosen for the survey because complete salary data are available and because this period covers what now appears to be a segment of business history ranging from the peak of prosperity to the bottom of depression. Corporate earnings of this group reached a peak in 1929 and a bottom in 1932. No attempt will be made to interpret the trend of earnings in relation to compensation in 1928.

Percentage of Earnings Paid in Total Compensation

With total executive compensation and earnings available for each company, it is possible to arrive at a percentage ratio of compensation to earnings for all companies for 1929, as well as for the five-year period 1928–1932. In Table I the 100 companies are ranked according to this percentage ratio for 1929. The table also indicates for each company in 1929 total executive compensation (column 2), total earnings (column 3), and total assets (column 4); and the percentage of earnings paid in total executive compensation in the five-year period (column 5). By the ranking method (median)[6] 50 companies fall in the low compensation group and 50 in the high group. The fiftieth company in the low compensation group has a ratio of executive compensation to earnings of 6.55%, and the fifty-first company, or first in the high compensation group, 6.64%; thus, the median paid by the entire group can be fixed between the two, 6.6%, and the percentages of all other companies for 1929 can be related to this figure. It can be concluded from this that around 6½% of earnings was the average amount paid executives by industrial companies in 1929.

Even by a cursory examination of columns 1 and 4 (Table I), it can be seen that as a rule the companies with large assets pay a smaller percentage of earnings to executives than do the companies with small assets. This is true for 1929 as well as for the five-year period. Also the median percentage paid by small companies is 9.7% as contrasted with 4.1% for the large companies (Table II, page 218). There are, however, notable exceptions to this conclusion. About 25% of the small companies fall into the low compensation classification, and 25% of the large companies fall into the high compensation group. The Lambert Company is an outstanding example of a company with small assets in the low compensation group. With assets of $7,000,000, it paid in total executive compensation 3.59% of earnings in 1929 and 5.1% as a five-year average. A notable example of a large company in the high compensation group is the Bethlehem Steel Corporation.[7] With assets of $802,000,000 the percentage of earnings paid in executive compensation in 1929 was 6.92%, slightly more than the median. The evidence available, however, concerning the percentage paid by large and small companies to their executives indicates rather conclusively that as a rule large companies pay a smaller percentage of earnings than do small companies.[8]

[6] Throughout this study frequent use has been made of the median; that is, the value which half the companies exceeded and half the companies fell below has been used as the representative figure. This choice was made because certain companies would have disproportionate weight if an arithmetic average were to be employed. For example, the arithmetic average total compensation for the high compensation group would be $300,000 whereas the median is $175,000. The latter figure is much more typical than the former, which is heavily weighted by two or three extreme items.

[7] Table I indicates other outstanding examples.

[8] In several different investigations of possible quantitative relationship between executive compensation and assets or earnings, the evidence indicated very

The contrast between the ratio of total executive compensation to earnings for the one-year period 1929 and the five-year period 1928 to 1932 (Table I, column 5) is one of the most interesting in the entire study. With earnings declining rapidly after 1929 in the longer period, the rising ratio indicates the roughly stable nature of executive compensation.[9] The median rose from 6.6% in 1929 to 10.8% for the five-year period. However, the effect

TABLE II

PERCENTAGE OF EARNINGS PAID TO EXECUTIVES IN 1929 BY LARGE AND SMALL COMPANIES, AND DISTRIBUTION OF HIGH AND LOW COMPENSATION COMPANIES BY ASSETS

	Small Companies (Assets less than $30,000,000)	*Large Companies (Assets of $30,000,000 or over)*
Percentage of earnings paid to executives (median %)	9.7%	4.1%
Number of companies in the *low* compensation group	12	38
Number of companies in the *high* compensation group	37	13

on certain specific companies is phenomenal. For example, the Grigsby-Grunow Company's ratio rose from 4.46% in 1929 to 353.0% for the five-year period (*i.e.*, over 3½ times earnings); and the Lee Tire & Rubber Corporation rose from 9.22% in 1929 to 293% (*i.e.*, almost three times earnings).[10] It is also interesting to note that several of the companies paid a smaller percentage of earnings for the five-year period than for the one-year (for example, General Foods Corporation) and also that a small group of them did not even earn executive salaries in either period. From these exceptional examples, as well as from the comparison of the ratios for the year 1929 and for the five-year periods, a question may well be raised as to the wisdom of paying executives additional compensation on the basis of any one year's performance.

Relationship between Total Executive Compensation and Earnings

The question of relationship between earnings and total executive compensation over a period of years involves many more problems than the first question, and is therefore approached from numerous angles with the aim of checking each analysis with other analyses. The first step is to get a general picture of the percentage of earnings paid by the companies in total executive compensation. The ranking of all the companies according to this percentage in 1929, as indicated in Table I, shows clearly great variations among companies, as, for example, the spread between 0.54% for the United States Steel Corporation, and the payment of salaries larger than total earnings by the American Woolen Company.

In this study the median figure (6.6%) is the dividing line between high and low compensation groups, those paying a larger percentage than the median being classified in the high group and those less in the low group.

The ranking of companies by the one-year average gives about the same results as by the five-year average, so far as high or low classification is concerned; only 9 companies change from one group to the other. The 1929 period was selected for the ranking of the companies because earnings and com-

little correlation. These studies included direct correlation analysis of executive compensation and earnings, and of executive compensation and assets; examinations were also made of the relation between percentage of earnings paid executives and the ratio of earnings to assets, and also of the relation between percentage paid executives and assets.

[9] Baker and Crum, *op. cit.*

[10] The rise in the percentage is mainly due to the fall in the denominator-earnings.

pensation were then at a peak, which should mean, theoretically at least, that the incentive to executives for the continued successful operation of their companies would be greatest. The selection of 1929 as a base should favor the theory that high compensation secures better corporate earnings. Also, since the earnings of these two groups over a period of five years are to be contrasted, the use of the one-year period merely for segregating companies into the two groups is believed to be statistically sounder.

TABLE III

CHARACTERISTICS OF HIGH AND LOW COMPENSATION GROUPS IN 1929

	Assets (*Unit* = $1,000,000)	*Earnings* (*Unit* = $1,000,000)	*Total Executive Compensation* (*Unit* = $1,000)
Total for *low* compensation group (50 companies)	9,995	1,017.8	27,531
Total for *high* compensation group (50 companies)	2,224	158.4	15,049
Total for entire 100 companies	12,219	1,176.2	42,580
Median of *low* compensation group (50 companies)	76.7	9.0	400
Median of *high* compensation group (50 companies)	17.5	1.6	175
Median of entire 100 companies	32.5	3.5	250

Table III summarizes certain significant characteristics of the high and low compensation groups. An outstanding difference is in the amount of the total assets, which in the low compensation group is about 4½ times that of the high compensation group; and total earnings for the low compensation group are slightly over 6 times those of the high compensation group. Total executive compensation of the low group, however, is less than twice that of the high compensation group. Or, expressing this differently, total executive compensation of the low group is only 2.7% of total earnings, while for the high group it is 9.5% and for the group as a whole only 3.6%. Comparable results are obtained by contrasting these percentages with the median figures paid in the low, high, and combined compensation groups.

Effect of Compensation on Earnings

With the companies classified into high and low compensation groups the second step may be taken which is to answer the question of whether there was less fluctuation in earnings throughout the 1928–1932 period in those companies paying high compensation than in those in the low compensation group.

TABLE IV

CHANGES IN EARNINGS* AND INDEX NUMBERS† OF HIGH AND LOW COMPENSATION GROUPS, 1928–1932‡

	1928		*1929*		*1930*		*1931*		*1932*	
	Amt.	*Index Number*	*Amt.*	*Index Number*	*Amt.*	*Index Number*	*Amt.*	*Index Number*	*Amt.*	*Index Number*
Earnings of 50 companies in *low* compensation group	$841	83	$1,018	100	$627	61.5	$303	29.5	$143	14
Earnings of 50 companies in *high* compensation group	$116	72	$ 158	100	$ 79	49.5	$ 20.5	14	(−$ 31.7)	(−20)
Total Earnings	$957		$1,176		$706		$323.5		$111.3	

* Unit = $1,000,000.

† 1929 = 100. See Chart I.

‡ Both compensation groups contain some exceptional companies but if these were omitted there would be no material change in the relatives from year to year.

Total earnings for the entire group as well as for the high and low compen-

sation groups are given in Table IV and are graphically traced, after being converted into relative numbers, on Chart I. The evidence appears clear that earnings in the high compensation group fluctuated more widely and declined further after 1929 than in the lower group. Earnings in the low group dropped from over one billion dollars in 1929 to $143,000,000 in 1932, while during the same period earnings in the high group fell from $158,000,000 to a deficit of $31,700,000.

The figures, it must be noted, are averages, and open to all the criticisms of any average. Particularly in this inquiry is the averaging open to criticism on the basis of variation in size of companies and variations in earnings because of the different industries or types of product.

Effect of Varying Assets on Findings

To avoid the criticism that the size of the companies might affect the validity of the conclusion, the entire group of companies may be divided on the basis of total assets in order to examine and compare the relationship of earnings and compensation in the large and small groups. A careful examination of the assets of the companies indicated that approximately half of them had assets of $30,000,000 or less and half of them assets over $30,000,000. A division of the 100 companies was made, therefore, with $30,000,000 as the upper limit of the small companies and the lower limit of the large companies (Table V), but the results vary little from the general study. The chief point to be noted is that the earnings of both small and large companies in the high compensation group fell more from 1929 to 1932 than for similar size companies in the low compensation group.

CHART I

CHANGES IN RELATIVE EARNINGS OF "HIGH" AND "LOW" COMPENSATION GROUPS BASED ON 1929 EARNINGS

1929 = 100

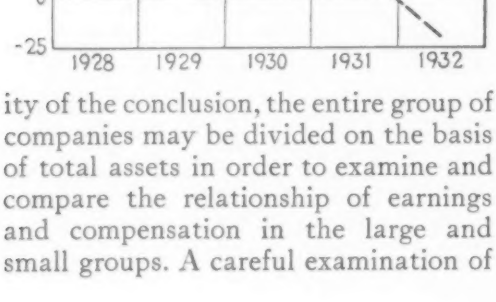


TABLE V

DECLINE IN EARNINGS OF HIGH AND LOW COMPENSATION GROUPS BETWEEN 1929–1932 BY ASSET GROUPS*

	Companies with Assets Less Than $30,000,000	*Companies with Assets of* $30,000,000 *and Over*
Percentage of earnings paid executives	9.7%	4.1%
Low compensation group declined (50 companies)	−97.0	−90.0
High compensation group declined† (50 companies)	−108.0	−127.0

* Because of the size of sample, attention should be given to the direction of the changes rather than to the definite changes in percentages in this and other tables.

† A decline of more than 100% indicates the existence of a deficit.

Companies Manufacturing Producer and Consumer Goods

Any sample of industrial companies is likely to include companies from two general categories, those manufacturing industrial goods and those manufacturing consumer goods. Since it is generally recognized that these two groups are differently affected by business conditions, an examination of the companies falling in the two groups seemed necessary to see if any results might be obtained which would affect the conclusions of this study (Table VI). The first outstanding conclusion from the result of this inquiry agrees with

existing knowledge of the trend of earnings of these two groups during a depression; that is, earnings of companies manufacturing industrial goods declined more than earnings of companies manufacturing consumer goods.

Here again no changes are revealed which in any way impair the validity of earlier evidence. Earnings for companies in the high compensation group for both industrial and consumer goods drop substantially more from 1929 to 1932 than for companies in the low compensation group. Also the drop in earnings for the companies manufacturing industrial goods as contrasted to that for the companies manufacturing consumer goods is noteworthy. In the low compensation group, earnings in the five-year period for the industrial goods companies drop 113% to a deficit, and for consumer goods companies, earnings drop only 67%. In the high compensation group the earnings of industrial goods companies drop 124%, likewise to a deficit, and those of consumer goods companies drop 98%.

TABLE VI*

DECLINE IN EARNINGS OF HIGH AND LOW COMPENSATION GROUPS CLASSIFIED ACCORDING TO INDUSTRIAL GOODS AND CONSUMER GOODS FROM 1929 TO 1932

	Industrial Goods Companies	*Consumer Goods Companies*
Low compensation group (50 companies)	−113%	−67%
High compensation group (50 companies)	−124%	−98%

* A decline of more than 100% indicates the existence of a deficit.

Bonus and Non-bonus Paying Companies

Much has been written about executive bonus plans or incentive compensation. By means of these plans, their proponents believe that executives will be given a feeling of proprietorship which will become a substitute for ownership and encourage them to strive hard for increased earnings. Let us examine briefly the results of the application of this theory.

As stated in the beginning of this article, it is assumed that the owners, *i.e.*, the common shareholders of a corporation, are chiefly interested in earnings. They desire their directors to employ executives who will manage their companies successfully, and they are willing to pay their executives on this basis. For this reason (or so it is generally assumed) elaborate bonus plans have been devised and substantial payments made in addition to salaries. These plans are used by two-thirds of the companies studied, and their prevalence suggests that the company directors feel fairly certain of the results to be secured by offering additional incentives. But are these assumptions based on facts? The results of this study should throw light on this question. A simple comparison can be made for the period studied of the change in the earnings of the two groups, those paying bonuses and those which do not. If incentive in the form of additional compensation is effective, then the companies paying a bonus should have decidedly steadier earnings, or a smaller drop in earnings during the period studied, than those that do not use a bonus plan.

Table VII and Chart II give the results of this special study. Although no exceedingly important variations from the previous conclusions occur here, nevertheless it appears that the bonus paying companies had an advantage over the non-bonus paying companies for every year, so far as a drop in earnings was concerned. The difference, however, is slight, particularly in 1932. Because of the difference in the number of companies in each group and other factors, too much emphasis

should not be placed on this comparison. Also other characteristics of the bonus and non-bonus paying companies doubtless affected these conclusions somewhat. For example, there was an equal number of bonus and non-bonus paying companies in the small asset classification; but there were three times as many bonus-paying companies in the large asset group as there were non-bonus paying companies. Also approximately two-fifths of bonus paying companies are in the high compensation group and three-fifths in the low compensation group. One-third of the bonus paying companies were in the consumer goods group, and two-thirds in the industrial goods group.

TABLE VII

CHANGES IN EARNINGS* 1928–1932 AND INDEX NUMBERS† FOR COMPANIES PAYING BONUSES AND THOSE NOT PAYING BONUSES IN 1929

	1928		*1929*		*1930*		*1931*		*1932*	
	Amt.	*Index Number*	*Amt.*	*Index Number*	*Amt.*	*Index Number*	*Amt.*	*Index Number*	*Amt.*	*Index Number*
Earnings of 62 companies paying bonuses in 1929	$784	78	$1,006	100	$622	62	$292	29	$95	9.5
Earnings of 38 companies not paying bonuses in 1929	$173	102	$ 170	100	$ 84	49.5	$ 31	18.5	$14	8

* Unit = $1,000,000.
† 1929 = 100. See Chart II.

Total Compensation as a Percentage of Sales

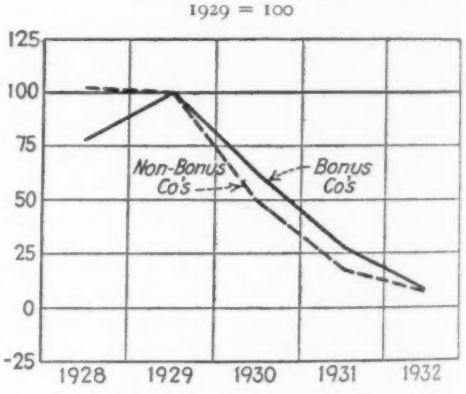
Instead of securing a ratio between total executive compensation and earnings, on which to base a study of executive compensation and its relationship to earnings, the basic figure ordinarily taken would be executive compensation in relation to net sales. This did not appear feasible as the chief approach to the problems presented by this article, since only 50 of the 100 companies analyzed furnished sales figures. Before concluding this survey, however, an examination should be made to see if the results of such a study would vary greatly from the evidence secured on the basis of earnings.

Table VIII and Chart III reveal clearly the results of this examination. The percentage of sales paid in total executive compensation for each company was found and the companies were classified according to those falling in the high and low compensation groups. A comparison was made of the earnings of the two groups for the five-year period 1928–1932. The results, although definitely limited in significance because of the small number of companies studied, agree with those previously secured—that the earnings of companies in the high compensation groups declined more over the entire period than of those paying low compensation. While there was some variation from this in 1930 and 1931, it was so slight as to be of little significance.

CHART II

CHANGES IN RELATIVE EARNINGS FOR BONUS AND NON-BONUS COMPANIES

1929 = 100



Other interesting information is brought out by the examination of total compensation related to sales. Small companies generally pay a higher percentage of sales for executive compensation than do large companies. Also the companies paying a high percentage of sales are practically the identical companies which pay a high percentage of earnings.

TABLE VIII

CHANGES IN EARNINGS* AND INDEX NUMBERS† OF 50 COMPANIES PAYING A HIGH AND LOW PERCENTAGE OF SALES TO EXECUTIVES 1928–1932‡

	1928		*1929*		*1930*		*1931*		*1932*	
	Amt.	*Index Number*	*Amt.*	*Index Number*	*Amt.*	*Index Number*	*Amt.*	*Index Number*	*Amt.*	*Index Number*
Earnings of 25 companies paying a *low* percentage of sales to executives in 1929	$441	77	$573	100	$267	46.5	$79	14	(−$9)	(−1.5)
Earnings of 25 companies paying a *high* percentage of sales to executives in 1929	$82	68	$120	100	$73	61	$18	15	(−$17.6)	(−14.5)

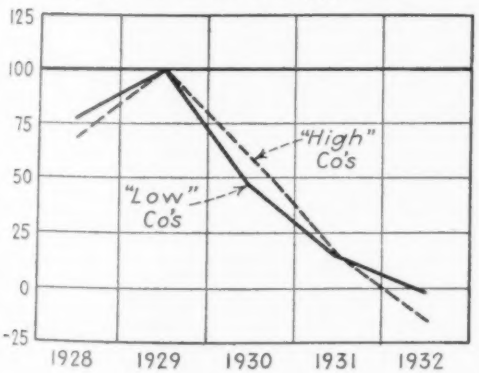
*Unit = $1 000,000.

† 1929 = 100. See Chart III.

‡ Both *high* and *low* groups contained a few exceptional companies but if these were to be omitted there would be no material change in the relatives from year to year.

CHART III

CHANGES IN RELATIVE EARNINGS FOR COMPANIES PAYING "HIGH" AND "LOW" COMPENSATION TO OFFICERS BASED ON 1929 SALES



Conclusions

Exceedingly difficult problems have arisen and are arising constantly on the subject of the proper rewards to corporation executives. Not only were there no answers to these problems in the past, but neither were there any methods or means of examining them in a general way. In this study evidence relating to these problems is assembled. The statistical methods used are not the exact tools to answer all questions relating to compensation but, in the writer's opinion, they are sufficiently precise to indicate the following significant conclusions:

(1) In general, companies with small assets pay a larger percentage of earnings to their executives than do companies with large assets. That such a situation must exist because of the difference in size is *not* borne out by this inquiry, since one-fourth of the small companies are classified in the so-called low compensation group and about the same proportion of the large companies in the high compensation group.

(2) The spread in the percentage of earnings paid as executive compensation from a very prosperous year, 1929, to the average for the good and bad years, 1928–1932, is not exceedingly great—only 4.2%. There are, however, certain companies in which the spread is exceptionally large. For this reason any method of compensation used by any one company on only one year's

performance may give highly unsatisfactory results.

(3) There is no substantial statistical evidence that directors of corporations either increase earnings or decrease fluctuations in earnings by paying executives a high percentage of earnings. Indeed the opposite apparently occurs; those paying a high percentage of earnings secure less satisfactory results than those paying a low percentage of earnings. No variation from this evidence appears either in large or in small corporations or in corporations in such different fields as industrial goods and consumer goods.

(4) Evidence indicates that other factors far more powerful than executive compensation are affecting corporation earnings. One of these influences certainly is the fluctuation in business conditions. The normal sequence of events for this factor seems to be much as follows: business slows down, demand slackens, sales fall, and earnings decline. From this inquiry it seems fair to conclude that no method of paying executives, no matter how liberal, can offset substantially this cycle of events.

CYCLICAL BEHAVIOR OF TIME DEPOSITS IN THE UNITED STATES

BY LAWRENCE W. TOWLE

RECENT discussions of time deposits have implied a marked cyclical movement of these deposits. J. M. Keynes[1] has found this movement to be dependent upon the cyclical behavior of security (stock) prices and the alternative uses of funds in the purchase of stocks or in time deposits. Elmer Hartzel,[2] whose discussion is based in part upon Gustav Cassel's theory of conjuncture-movements,[3] has found the volume of time deposits dependent upon the amount of money available for investment purposes, and also that it is affected by changes in the rate of interest and by readjustments in the relationship between fixed and circulating capital.

According to Keynes, the rise in security prices during the early upturn of business from depression creates a general feeling of optimism among investors who find it desirable to withdraw funds from savings deposits to buy securities.[4] After security prices have risen considerably, there is a division of sentiment, some of the "bulls" turning "bearish" and selling their securities to others who are willing to buy stocks on borrowed money, the proceeds from the sales going back into time deposits. When security prices turn downward, there is a unanimity of "bearish" sentiment and an increase in savings deposits as securities are liquidated.[5] Thus, there is developed a distinct cyclical movement of time deposits. In the upswing of the cycle they are drawn down and transferred to demand deposits by way of the securities markets, at least until the upward movement gains considerable momentum, and near the peak and in the downward phase they are built up as securities are sold and funds are transferred from demand deposits.

Hartzel,[6] citing Cassel, believes there is a relatively considerable formation of capital at the beginning of an upward swing of business; individuals save a greater proportion of their incomes, and corporations realize greater profits because wages are low and business is expanding. This is followed by advances of wages and prices, which result in a diminution in the rate of capital formation because the working classes begin to consume a large part of their income and corporations experience rising costs relative to prices, with resultant lower profits; and, as the peak of the cycle approaches, a stringency in the supply of capital (savings) begins to develop. The significance of such an analysis with respect to deposits resides in the fact that changes in the rate of capital formation are accompanied by continuous readjustments in the relationship of fixed to circulating capital. An increase or decrease in

[1] *A Treatise on Money*. New York: Harcourt, Brace and Company, 1930. 2 vols.

[2] XIII HARVARD BUSINESS REVIEW 1, October, 1934, p. 33.

[3] *Theory of Social Economy*. London: T. F. Unwin, Ltd., 1923. Trans. by Joseph McCabe.

[4] *Op. cit.*, Vol. I, p. 251.

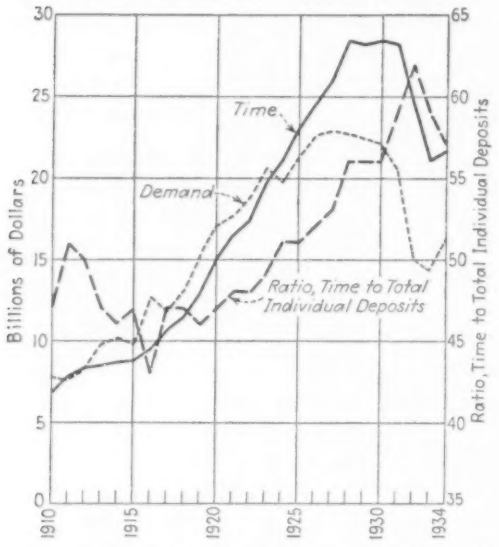
[5] *Ibid.*, Vol. I, pp. 252–253. Keynes does not deny the presence of true thrift accounts in time deposits.

[6] *Op. cit.*, pp. 40–41.

fixed capital relative to circulating capital will be accompanied by an increase or decrease in time relative to demand deposits. The composition of deposits in the banking system would, therefore, be expected to undergo transformations which would conform to major oscillations in the rate of interest, since the effect of a change in the rate has an unequal effect on the relationship of fixed to circulating capital, and indirectly on time and demand deposits.[7] The lowering of the "real" rate of interest widens the use of capital goods, and builds up time and savings deposits, whereas a rise in the rate tends to have the opposite effect.[8] Briefly: time deposits increase rapidly during early recovery and taper off as the boom develops.[9]

CHART I

TIME AND DEMAND DEPOSITS—ALL BANKS IN THE UNITED STATES, 1910–1934 (ON JUNE 30)



The present article undertakes to analyze the figures for time deposits in the banks of the United States since 1914, to explain what cyclical movements may be found therein, and to determine whether those movements can be reconciled with the theories of Keynes and Hartzel.

Statistics of Time and Demand Deposits in Commercial Banks

Examination of Chart I, showing time and demand deposits in all banks in the United States for the years 1910–1934, fails to reveal any decline in the curve of time deposits until 1929. The depression of 1920–1921 did not halt the growth of time deposits, evident since 1910. But the fact that these are annual figures and also that they do not depict a marked cyclical behavior in demand deposits makes of interest a study of the statistics of time and net demand deposits in all member banks (Chart II) which are available at each call date. Even in member banks, however, a marked drop in net demand deposits in 1920–1921 is not accompanied by a simultaneous decline in time deposits; and the persistent growth noticed in the time deposits of all banks up to 1928 is also remarked in these deposits for member banks.

Although time deposits in member banks did not decline in any year before 1928, in certain years they increased much more rapidly than in others: notably in 1917, 1919, 1922, 1923, 1924, and 1927, when the annual increase was one billion dollars or

[7] *Ibid.*, p. 39.

[8] *Ibid.*, p. 40.

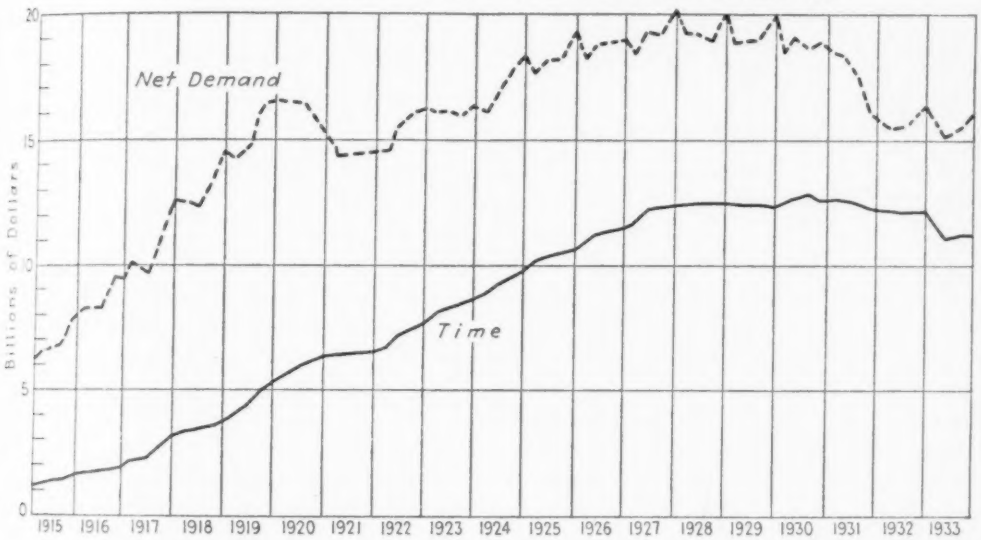
[9] From Hartzel's discussion it is not certain how time deposits would move during recession. While a decrease in fixed capital formation would lead to a reduction of time deposits, he also states (p. 41) that there is a tendency for deposits to shift from current to savings accounts when prices are falling and need for a rapid turnover of money is reduced.

Study of Chart I shows that the increase in the ratio of time to total individual deposits in all banks in the United States from 1930 to 1932 was due entirely to the liquidation of demand deposits and not to the shifting of demand to time accounts.

greater. But instead of the inverse correlation with demand deposits which the Keynes thesis implies, it is seen that each of these six years except 1923, which showed the smallest growth in time deposits of any of the six, was also a year of marked expansion in demand deposits. It is not unnatural, however, to expect an increase in time deposits at a time when demand deposits are expanding. Demand deposits generally expand with a quickening of business activity; and greater business activity means fuller employment, an increase in wage rates, and larger corporate profits, with consequently larger dividend distributions to stockholders. With more money in the hands of the working and stockholding classes, it is to be expected that these classes will make larger total savings. A large part of the savings of wage-earners goes into savings accounts, and many stockholders make a practice of depositing dividend checks in savings accounts. At the same time, larger business profits make possible the strengthening of the financial positions of business firms and corporations out of earnings, and some of this cash surplus is likely to find its way into time deposits.[10]

CHART II

NET DEMAND AND TIME DEPOSITS——ALL MEMBER BANKS, 1914–1933



[10] Whether the enormous increase in time deposits in the United States since the War represents a growth of thrift accounts or a more careful analysis of cash needs by business concerns with a shifting of what might otherwise have been demand deposits to time deposits, was widely discussed during the late twenties. It is the belief of the writer that the growth of thrift accounts was the more important factor in this increase but that the increase in the commercial funds carried in time deposits was by no means inconsiderable, particularly in the larger cities. Inquiries among bankers in the East have revealed that it was a fairly common practice for firms and corporations to carry sizable time deposits. One case was called to the attention of the writer in which a bank in one New England textile city held $5,000,000 in time deposits belonging to six corporations. The Committee on Bank Reserves of the Federal Reserve Board found (May, 1931) that, of $13,000,000,000 of time deposits held by member banks at that time, $3,000,000 000 consisted of individual accounts with balances in excess of $25,000. *Cf. Report*, pp. 14–15. Probably a good proportion of these were commercial accounts.

But it seems incredible that bankers induced customers to shift deposits from demand to time accounts, as many have claimed. By so doing, to be sure, a banker would reduce his reserve requirements, say from 13% to 3%; but, having to pay at least 2% more

Time deposit figures for all banks and all member banks from 1910 to 1928 apparently offer little in support of the Keynes or Hartzel theories. But what of the period since 1928? From 1928 to 1930 there was virtually no growth in either group, but neither was there a decline; while after 1930 a marked decline occurred. Keynes may find some consolation in the behavior of time deposits during 1928 and 1929, as the end of the long period of growth was in considerable part undoubtedly influenced by stock market conditions. Visions of an El Dorado drew many a savings account into the stock market in these months; and the high money rates induced many corporations to draw down their inactive bank funds (time deposits) to lend in the open market.[11] But this shift to the "bull" position developed late in the upturn of business, not early as Keynes would intimate. Apparently, savings depositors were "from Missouri" and required considerable demonstration of the magnificent profit opportunities in the stock market before they could be tempted to abandon the less dazzling but relatively safe haven of the banks. Certainly, it is difficult to reconcile the Keynes theory with the drop in time deposits after 1930, when there was an almost continuous decline in stock prices for a period of more than two years. According to that theory, time deposits should have risen during this period. Verification of the Hartzel thesis, too, may possibly be found in the years 1928–1929. Higher incomes and visions of a new economic era may have dimmed the desire to save; on the other hand, the volume of savings may have been as great as earlier, but savers may have altered their routes of investing, preferring direct investment in securities or real estate to time deposits.

Deposits in Mutual Savings Banks

Of further interest in considering this (Hartzel) thesis is a recent study of the cyclical behavior of deposits in the mutual savings banks of New York State covering the period 1875–1930, made by Leonard P. Ayres.[12] Ayres found that over a long period following 1875 there have been declines in savings in all major depressions. Generally, the American people do not draw down their money in savings accounts, and replace it, concomitantly with the movement of the business cycle, but on a plan of procedure that if diagrammed would make a quite different sort of curve. At the early part of a period of depression the decline in savings runs down abruptly. It recovers promptly and goes up to a high point long before business has really become good again. It starts gently to decline as prosperity goes on progressively increasing. He concludes that when the people are feeling really prosperous they clearly do not save in

interest to the depositor on the time deposits than on the demand deposits (*Cf. Federal Reserve Bulletin*, 1928, p. 828), he would find it unprofitable. On a $1,000 deposit there would be a reduction in the reserve required of $100, which, loaned at 6%, would increase the bank's gross income by $6. But the increase in interest paid by the bank as a result of the transfer would be $20, making a net loss of $14 on the transaction. For reserve city and country bankers, such a transfer would be even less profitable because of the lower reserves required on demand deposits.

It is not to be doubted, however, that, during a period when competition among banks was especially keen, bankers did offer the high time-deposit rates on new deposits when these accounts could be attracted in no other way. And in some instances a similar inducement may have been necessary to hold old accounts in the face of aggressive competition.

[11] Federal Reserve Bank of New York, *Monthly Review*, April, 1930.

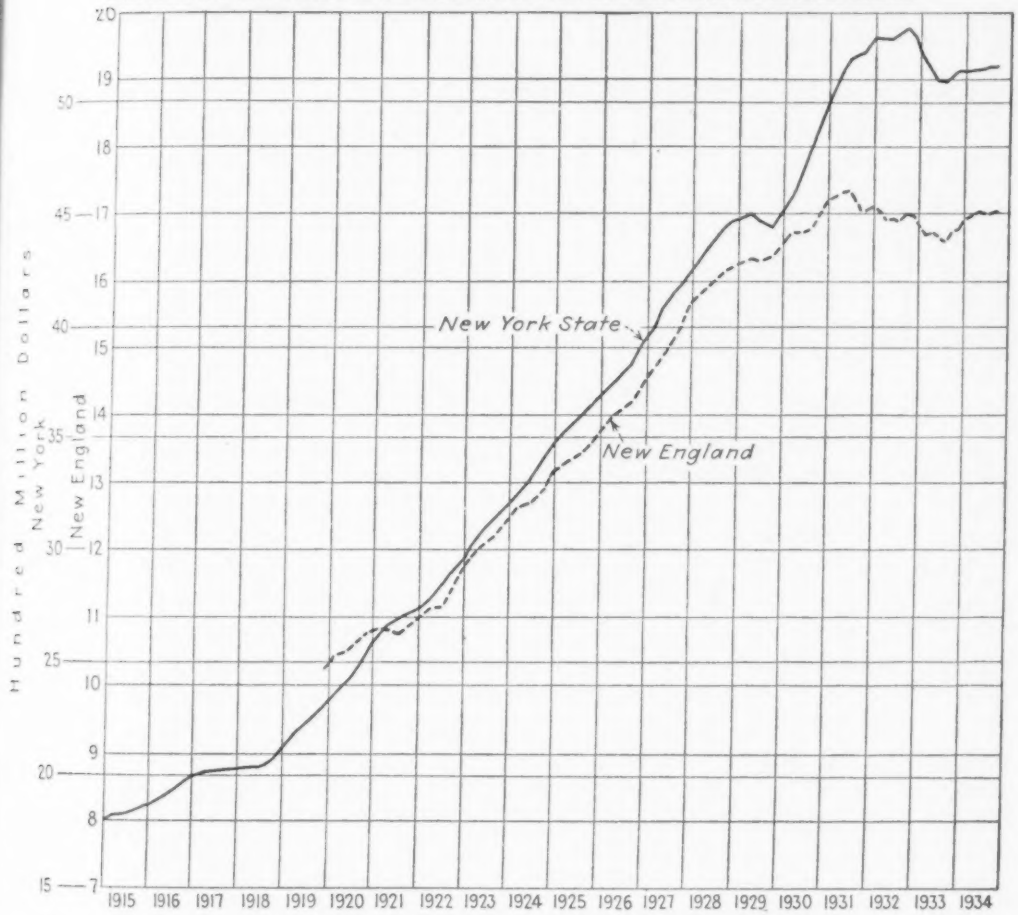
[12] *Commercial and Financial Chronicle*, Section 2, October 18, 1930, pp. 102–106.

proportion to that prosperity. Thus, he finds cycles of business tend to lag somewhat behind cycles of savings.

However, these conclusions Ayres found much more applicable to conditions several decades ago than to the past decade or two; and evidence of the inapplicability of these conclusions to the last six years is presented in Chart III, showing deposits in New York State mutual savings banks and 62 New England mutual banks for the past two decades.[13] Although both groups experienced a slight loss of deposits in 1929, this was followed during the first two years of the depression by a sharp rise, and not until late in 1931 in the New England banks and in 1932 in the New York banks did a true cyclical decline appear. This delay in the decline, as compared with that in member banks, represents in part a shifting of deposits from the commercial to the mutual banks, the

CHART III

DEPOSITS IN NEW YORK STATE BANKS AND 62 NEW ENGLAND MUTUAL SAVINGS BANKS

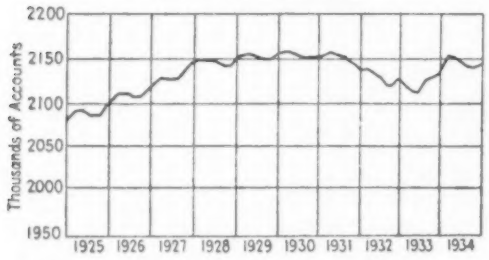


[13] For the statistics of the New England savings banks I am indebted to the Financial Statistics Division of the Federal Reserve Bank of Boston. The New York figures are taken from the reports of the State Bank Department and the State Savings Banks Association.

numerous failures among commercial banks undermining somewhat public confidence in them.[14] But the fact that the number of accounts on the books of the New England savings banks declined by approximately 50,000 (Chart IV) from early 1931 to the middle of 1933, while the average balance per account (Chart V) did not

CHART IV

NUMBER OF ACCOUNTS ON BOOKS OF 62 NEW ENGLAND MUTUAL SAVINGS BANKS



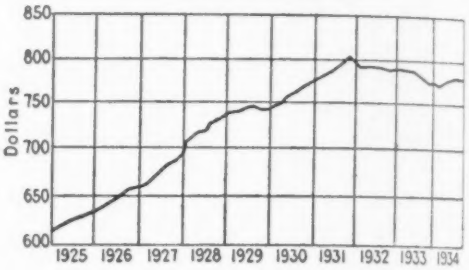
decline until late in 1931 and then only slightly until the middle of 1933, implies a transfer of investment funds from the securities markets to time deposits. The decline in the average balance during the latter half of 1933, when the number of accounts was increasing and total deposits decreasing, may signify the withdrawal of funds for investment purposes at a time when the business outlook was promising, and may also reflect the influence of many small new accounts the effect of which is to dilute the average balance.

The decline in time deposits in all banks and member banks during 1931, 1932, and 1933 reflects to a considerable extent bank suspensions, the deposits of suspended banks not being included in the statistics. But that this is not a complete explanation of the decline is evident from the decline in the deposits of the 62 New England mutual savings banks, among which there were no suspensions. Hoarding and distress withdrawals due to unemployment were the chief causes of the decline in these banks, and were probably important factors in the decline in all banks and member banks.

In none of these groups of banks is there evidence of an upturn in time

CHART V

AVERAGE BALANCE PER ACCOUNT IN 62 NEW ENGLAND MUTUAL SAVINGS BANKS



deposits until the latter part of 1933. The lag of cycles in business behind cycles of savings, which Colonel Ayres found in the deposits in New York mutual savings banks before 1910, has evidently been reversed during the last six years. While business turned downward in 1929, in no case did time deposits turn definitely downward until late 1930, and in the mutual banks not until 1931 in New England and 1932 in New York State. And whereas the upturn of business from the depression began in 1932 and continued, somewhat spasmodically, to be sure, through 1933 and 1934, the decline in time deposits was not reversed until late in 1933.

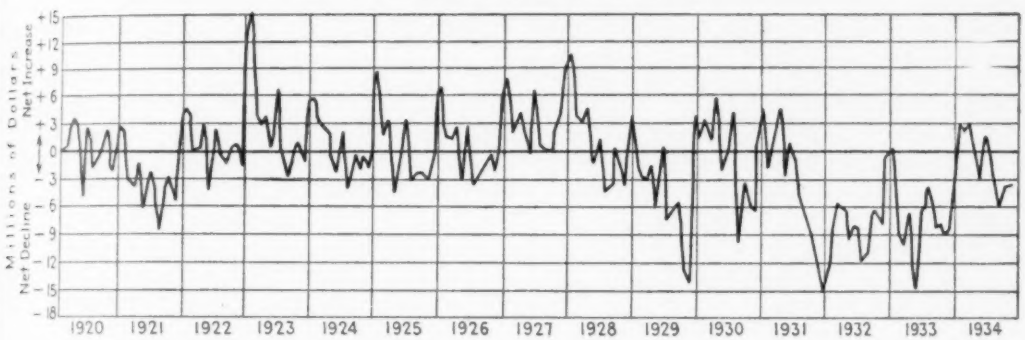
The increase in the number of accounts in the 62 mutual banks in New England, noticeable a few months before the increase in the deposits of these banks, suggests that the return of funds from hoarding was an important factor in the upturn in deposits. And, undoubtedly, the increase in

[14] *Cf.* Federal Reserve Bank of New York, *Monthly Review*, February, 1931, p. 2.

employment and the more optimistic tone of business were factors. However, the increase in the average balance per account which persisted throughout most of 1934, when the number of accounts was again declining, would indicate a transference of investment funds to savings accounts during this period of uncertainty in investment markets and low yields on prime investments.

CHART VI

NET NEW SAVINGS DEPOSITS——MONTHLY GAINS OR LOSSES ADJUSTED TO ELIMINATE ACCRUED INTEREST IN 62 NEW ENGLAND MUTUAL SAVINGS BANKS



The Factor of Compound Interest Accumulations

The failure of time deposits to display the cyclical movement which one might expect is due in considerable part to the stabilizing influence of compound interest accumulations. This influence is shown in Chart VI, prepared by the Financial Statistics Division of the Federal Reserve Bank of Boston and presenting monthly gains or losses to savings deposits in the 62 New England mutual banks adjusted to eliminate accrued interest. In this chart, marked losses of deposits are seen in 1921, in 1928–1929, and late in 1930, where in the actual balances in Chart III these losses either do not appear or are of slight importance. On more than one billion dollars of deposits, for example, compound interest accumulations for the year 1921 at only 4% would amount to $40,000,000; and more than this amount would have had to be withdrawn before any decline in gross deposits would become evident.[15] The degree of stabilization exerted by these interest accumulations is directly correlated with the rate of interest paid on time deposits, being greater, of course, when rates paid on deposits are 4% or 5% than when they are 2½% or 3%.

Savings and Capital Construction

The cyclical relationships which Hartzel traces, from a low rate of interest, to a relatively great formation of

[15] It is, of course, inaccurate to allow for interest accruals on the entire deposits, because there is a certain amount of withdrawals and replacements of deposits which interferes with interest accruals. Yet it is easy to overestimate the importance of this interference. Many savings banks and departments, certainly in New England and the East, find that marked activity is concentrated in comparatively few accounts, while the great backbone of their accounts experience relatively few withdrawals, and those are generally restricted to interest accretions. Another factor tending to minimize the effects of withdrawals upon interest accumulations is the rather widespread practice of paying interest from the first of the month following new deposits.

fixed capital as distinct from circulating capital, to an increase in time relative to demand deposits, seem rather tenuous. While there is little doubt that a low rate of interest, under propitious conditions, stimulates investment in fixed capital, it is very doubtful whether time deposits are as sensitive to cyclical changes in the rapidity of fixed capital formation as Hartzel intimates. The growth over the past century of fixed capital in industry, as distinct from agriculture, has undoubtedly stimulated the growth of time deposits. The decline in the relative importance of agriculture has diminished the opportunity for direct investment on the farm, while the expansion of fixed capital has raised the marginal productivity of labor, and hence wages, and despite a higher standard of living has resulted in a larger surplus to be invested. But savings originate with one group of persons, the construction of capital goods with a different group; and there is no essential reason why the two should always be equal. The very fact that the rate of interest is low at the beginning of business recovery and high near the peak of prosperity simply reflects, among other conditions, that in the first case the volume of savings is great relative to the demand for savings for capital construction, and in the latter that the supply of savings is scarce relative to capital-goods construction. The problems arising from this disequilibrium between savings and the value of capital-goods construction (investment) have been ably discussed by Keynes.[16]

Some indication of how disparate the movements of time deposits and fixed capital formation may be is found in the years 1928–1930, in which the growth of time deposits in all banks was either very small, nil, or less than nil. Yet, in 1928, construction contracts awarded were the highest for any year for which the Federal Reserve Board has published figures. While this figure dropped in 1929 and again in 1930, the drop was due entirely to a decline in residential contracts in 1929 and almost entirely to a decline in residential contracts in 1930, the drop in "all others" for this year being from 142 to 125. In so far as indices of production, factory employment, and factory payrolls in the iron and steel, machinery, and transportation equipment industries may be taken as indices of capital-goods construction, 1928 and 1929 were years of greater capital construction than the years preceding, and in the case of lumber production were only slightly below the years immediately preceding. Capital issues (exclusive of refunding issues) in these two years were the highest for the decade; and while these issues fell off markedly in 1930, even in that year they were higher than in any other year of the 1920's preceding 1927.[17]

Time Deposits and Gold Imports

One abnormal factor facilitated the growth of time deposits during the 1920's, *viz.*, the huge imports of gold which the United States received during the War and the years following the War. These gold imports, coupled with generous open-market purchases by the Reserve banks, enabled the member banks to reduce their indebtedness to the Reserve banks and at the same time put them in possession of large excess reserves. Unable to use these new funds in expanding

[16] *Op. cit.*

[17] Federal Reserve Board, *Annual Report for 1932*, pp. 165–179.

their commercial loans, the member banks bought bonds and made large aggregate loans secured by real estate and securities. This type of bank credit expansion, by means of investment purchases and secured loans, tends to result in a greater proportion of time deposits than expansion by means of commercial loans. When a loan is made for commercial purposes, it is generally to meet the expanding needs of trade, and the deposit is passed from one business man to another as a demand deposit. When the loans are negotiated for the purchase of securities, however, there is an expansion of deposits at a more rapid rate than the needs of trade demand. Persons who indirectly obtain newly-created bank funds through the sale of securities direct to the banks or to borrowers of bank funds may re-invest these funds, or may carry idle bank balances. Re-investment of funds involves passing on deposits to others. As they are passed from person to person, a portion of them will reach the hands of individuals who do not care to re-invest but will prefer to carry idle bank balances; and an idle bank balance is most profitably carried as a time deposit. Many of these investment purchases and security loans were, to be sure, merely indirect commercial advances, corporations preferring to take advantage of favorable security markets to finance themselves rather than to become directly indebted to the banks through short-term loans. But the fact that securities could be readily sold induced many corporations to finance themselves in excess of current requirements and to increase their cash reserves; and unneeded cash balances went into investments and time deposits. Thus, the ease with which bank credit could be obtained indirectly enabled investors and corporations to convert their investments and new securities into time deposits.

Conclusion

From the foregoing discussion it is evident that the banking statistics of the United States from 1914 to 1930 afford no significant grounds for a cyclical pattern of time deposits, and that the Keynes theory fails to explain the movement of these deposits after 1930. It is not to be gainsaid, however, that the shifting of funds from time deposits to the investment markets, and *vice versa*, is a movement which any study of time deposits must take into account. The relationship which Hartzel traces between fixed capital formation and the growth of time deposits, although perhaps of significance over a long period of years, seems to be too indirect and too tenuous to justify anticipation of parallel cyclical swings of these two phenomena during the shorter period of the business cycle. Moreover, it is to be doubted whether there is more saving early in business revival than later in a period of prosperity. Perhaps individuals save a larger *proportion* of their income in the early period; but it must be remembered that, in the later period, employment is fuller and wages higher so that even a smaller proportion saved out of individual incomes can easily result in a larger absolute volume of savings. And it is the *total volume* of savings which is important. The evidence of such indices of savings as life insurance premiums paid, assets of building and loan associations, new securities purchased, and mutual savings bank deposits points clearly to a tremendous volume

of new savings in the United States during the late twenties.[18]

The forces affecting the expansion of time deposits are complex. The growth of true thrift accounts is governed by such factors as the fullness of employment, the decision of the people to save or to consume, the choice made of investing savings, and the confidence of savers in the banks. But the presence in time deposits of investment and commercial funds makes incomplete any analysis of these deposits in terms merely to thrift accounts. Moreover, even if true savings funds were the only constituent of time deposits, cyclical movements of them would generally be obscured by compound interest accruals, except in cases of the most severe and long-drawn-out depressions. The number and complexity of the forces governing the growth of time deposits, and the fact that these forces are often working toward opposite results, make attempts at prediction hazardous.

[18] *Cf. Statistical Abstract of the United States*, U. S. Bureau of Foreign and Domestic Commerce, 1930.

Care should be taken, of course, not to make an aggregate of these four indices a measure of total savings, because banks and insurance companies in turn bought some of these new securities. A simple summation, therefore, would involve much double-counting. Also, time-deposit expansion and new securities purchased reflect the expansion of bank credit as well as saving.

ELASTICITY IN PUBLIC FINANCE

BY WARREN ALDRICH ROBERTS

THE need to prepare for a "rainy day" has never been as well recognized by the voter as by the business man, nor, oddly enough, is it as clearly a tenet of public finance as it is of business finance. During the twenties, when many corporations were taking advantage of market conditions to retire bonded indebtedness, and, in some cases, to refinance with convertible debentures and non-voting common stock, municipal corporations were assuming higher fixed charges. Municipal assumption of six billion dollars of new debt in the five-year period 1926 to 1930[1] no doubt bore some relation to the 1,830 defaults on issues of municipal bonds, notes, and certificates of indebtedness estimated as of June 1, 1934.[2] Yet while business failures are expected as the price of industrial progress, government insolvency is held to be rarely excusable.

The alarm during the twenties over rising government costs was most upon the point when it warned of future emergencies.[3] This paper is written in the belief that not only may a government, by foresight, avoid insolvency more easily than an individual, but that within what has been called the principle of elasticity lies an explanation of the sort of foresight that is needed.

Definition

Historically, the canon that a revenue system should be elastic lends itself to brief treatment. Adolph Wagner held that the tax system should have the capacity to adapt itself to changes in financial needs as well as the capacity to make up for the possible failure of any one source.[4] Bastable, writing in the nineties, interpreted this to mean "elasticity" or "the general principle of flexibility," and agreed that the public revenue should "admit of easy expansion or reduction according to the growth or decline of expenditure."[5] Lutz mentions elasticity as one of the requisities of a sound tax system, and states that the "elasticity of the tax system means that there should be the capacity to respond quickly to changes in the demand for revenue." As an illustration of an inelastic tax he cites the corporate gross earnings tax, which has a tendency to vary its yield with economic conditions.[6] According to Adarkar, elasticity denotes the expansibility of resources in response to the growing needs of the government con-

[1] *Cost of Government in the United States, 1929–1930.* National Industrial Conference Board, Table 13, p. 52.

[2] *The Bond Buyer*, Summary of State and Municipal Defaults, Revised to June 1, 1934.

[3] An illustration of this approach is to be found in an article by C. J. Bullock in 1928, which, in calling upon "expenditure control" to cope with lobbies, recalled the difficulties that faced cities in the eighties in their effort to liquidate debts "they ought never to have contracted." "The only prudent course," he concluded "is to put our house in order while there is yet time." "The Increase of Taxes on Real Estate in American Cities," VI HARVARD BUSINESS REVIEW 2, January, 1928, pp. 137, 142.

[4] Wagner, Adolph, *Finanzwissenschaft II*, pp. 306 ff. This principle (*Beweglichkeit*) he coupled with the principle that the yield of revenue should be adequate (*Ausreichendheit*) and held that both together formed the fundamental financial rule that revenue should always be sufficient to cover needs of the state.

[5] Bastable, C. F. *Public Finance.* New York: Macmillan Co., 1895, pp. 387–390.

[6] Lutz, Harley Leist, *Public Finance.* New York: D. Appleton & Co., 1929, pp. 280–281.

cerned or under the strain of sudden emergencies like war, famine, and pestilence.[7]

Included within the problems discussed under this principle are two sorts of emergency. In the first place we may assume constant economic conditions and consider that in case of emergency, such as war or flood or labor troubles, the state must be able to demand greater sacrifice from the taxpaying group, in the way of increased revenue. One of the immediate results of the Vermont flood of 1927 was an increase in authorized bonded indebtedness of $8,500,000.[8] In the second instance we assume business conditions to change for the worse, as in the present depression, and we consider that the government needs, not more revenue, necessarily, but a certain stability in revenue.[9] This sort of emergency, also, entails more sacrifice on the part of the taxpaying group. The common denominator of the two problems is the need for increased taxpayer sacrifice.

There are several reasons, of course, for making a distinction between the two types of emergency. As governments continue to demand a larger income and to take a more prominent part in industry, they need to be increasingly aware of the necessity to prepare for a business depression. The distinction must be made, from another point of view, because each type of emergency calls for a different type of tax. A property tax, for instance, will more readily bring increased sacrifice during a depression than an income tax, due in part to the inertia against changing rates and assessments. A third reason for such a distinction is that different types of government are apt to meet different types of emergency. Local governments, for instance, are only occasionally called upon to bear war expense or to aid in flood relief or labor troubles, but they must always be prepared to cope with economic difficulties.

Nevertheless, because both types of emergency call for the same fundamental quality of responsiveness, or elasticity of sacrifice, and because, as will be demonstrated, ability to meet one type of emergency will generally mean ability to meet the other, the two ought to be considered together. Only by this approach, moreover, is the relation made clear between the principle that a revenue system ought to be elastic, and the principle that local governments ought to have a certain amount of reserve strength.

Recent Experience

It would probably be advantageous if every governmental unit, at the conclusion of every emergency, might summarize its own peculiar experiences in partial preparation for the next. The public administrator who held office during the depression was made aware of a limit to the amount of revenue that could be raised. He knew, moreover, that such limit varied not only with general business conditions, but between localities. The state income tax is one illustration. Between 1928 and 1932 the yield of the Arkansas income tax dropped from $871,841 to $98,544, or 88%; that of North Dakota shrank from $613,702 to $91,711, or 85%; and the State of New York, in spite of doubled rates, raised only $30,000,000

[7] Adarkar, B. P., *The Principles and Problems of Federal Finance*. London: P. S. King & Son, Ltd., 1933, pp. 280 ff.

[8] *The New York Times*, December 17, 1927, p. 29.

[9] Bastable's definition does not appear to cover this point.

in 1932 as against $83,000,000 in 1929.[10] Even the West Virginia gross proceeds tax fell from $4,046,143 in 1927 to $2,327,711 in 1930.[11] Certain states, on the other hand, were able, with higher rates, to avoid so unhappy a shrinkage in revenue. Thus while the yield of the 1930 Oklahoma income tax was a little over half of the $1,089,000 raised in 1928, a change in rates produced over $2,000,000 in 1931 and maintained a return well over the million dollar mark in 1932 and 1933. In Missouri the difference between the yield of the best and worst years was only 28%, due in part to change in rate, and in Wisconsin the yield was steadied by computation of taxes upon a five-year average of private income. Because Arizona had never used a state income tax before the depression it was a source of strength, rather than weakness, in the budget.

An attempt to find the causes of these differences would probably reveal three factors: the severity of the economic depression in the particular locality, the effectiveness of the administration of revenue laws, and the willingness of the taxpayer to make additional sacrifice. The first item was out of the hands of the administrator—there was little he could do about the roughness of the road over which he was driving. The second and third, however, depended to a material degree upon the preparedness of that government to meet just such emergency.

True elasticity depends upon the government's ability to induce increased sacrifice from the taxpayers. How can that ability be acquired? It is no doubt fundamental that the administrator should assume that while the limit to taxpayer sacrifice varies widely with many conditions, such limit does exist and should be carefully avoided in normal times.[12] While only past experience will tell where that limit lies, many local governments were warned both before and during the depression. With mounting delinquency in 1928, defalcation on bonded indebtedness was almost assured for 1934, and states like Florida, North Carolina, and Louisiana, with defaults to the number of 330, 276, and 258, respectively,[13] should have considerable indication of the limits to which local property taxes may be successfully pushed. On the other hand, of the eight states free from such defaults (as of the same date), five were in New England, and the other New England state, Maine, had only one. It should be apparent that, considering the type of industry, administrative efficiency, and financial tradition, New England has been rather successful in avoiding that limit.

[10] Data on income tax collections secured by correspondence in 1934.

[11] Conley, W. G. "West Virginia's Experience with the Sales Tax," *Current Problems in Public Finance.* Chicago: Commerce Clearing House, 1933.

[12] In his discussion of the reasons why the limit of taxable capacity is not an absolute or fixed figure, Sir Josiah Stamp noted that such limit was influenced by the application of revenue, national psychology, the methods by which money is raised, the distribution of wealth, and the fact that capacity shrinks or increases more rapidly than change in the amount of wealth. (*Wealth and Taxable Capacity.* London: P. S. King & Son, Ltd., 1922, p. 118. See also Silverman, H. A., *Taxation, Its Incidence and Effects.* London: Macmillan and Co., Ltd., 1931, chap. III.)

Hugh Dalton (*Principles of Public Finance.* New York: A. A. Knopf, 1929, pp. 160 ff.), and B. P. Adarkar (*op. cit.*, pp. 200 ff.), take exception to the concept of "taxable capacity." Yet that there is a short-run problem is recognized by Adarkar when, under a discussion of Adequacy and Elasticity, he states that the expansibility of sources of revenue "depends on how far the tax-handles have been already exploited as to the rate-scales." (pp. 222 ff.) It seems to me that from the administrative viewpoint, and particularly in the short run, the problems of taxable capacity and elasticity are definitely related.

[13] Summary of State and Municipal Defaults, revised to June 1, 1934, *The Bond Buyer.*

Because of the amount of discussion upon this point, let us say that there is a certain similarity, here, between private and public business. Private enterprise, in any attempt to forecast future income, is faced by many imponderables, but it gives a useful answer by assuming that crop production will be somewhere near normal, that no invention will revolutionize production, and that competing factories will not be destroyed by fire. It is true that, in public business, the psychological response of the people may change markedly over a length of time—as during the excitement of war. It is true, also, that a new direction of expenditure may so affect economic life as to make a people more willing to pay taxes. Yet, to be businesslike, a state should not depend entirely upon any of these contingencies, but should assume that the elasticity of a revenue system will change little from decade to decade.

Gaining Elasticity

The foregoing discussion has been introductory to an attempt to list the methods by which a government may obtain a responsive revenue system. We have said that a factor lying partly in the hands of the administrator is the efficiency of enforcement machinery. Herbert D. Simpson noted in 1933 that tax delinquency was due "in considerable degree to a slow, cumbersome, ineffective process of collection in many states, and to ineffective administration of the processes that do exist."[14] Litigation is to be expected, during depressions, under the historic principle that, as the tax burden increases, a process of squirming calls for more careful and more expensive supervision of the distribution of that burden. Whenever enforcement machinery has had enough reserve strength to meet the need for more accuracy in assessments, to avoid political demagoguery, and to arbitrate justly between the several interests to be taxed, the state has avoided some of the financial difficulties of the depression. Where, as in Illinois,[15] there was lack of confidence in administration, litigation was frequent and elasticity was lessened.

Closely allied to this point is the need for legal and traditional freedom in the fixing of rates and assessments.[16] Where constitutional provisions are too restrictive, a government can scarcely adapt itself to changing conditions.

Other things being equal, however, the response of the taxpayers to demand for increased sacrifice will depend primarily upon the amount of additional sacrifice demanded, and this, in turn, will depend somewhat upon whether or not previous sources of government income were used with moderation.[17] This rule applies to both old and new taxes. Just as the Federal Government used new forms of revenue during the War, so 26 states levied new taxes on sales between 1929 and 1935.[18] If these state sales taxes had been in use in 1928, public expenditures would

[14] "Tax Delinquency, Economic Aspects," *Illinois Law Review*, June, 1933, p. 151.

[15] Simpson, Herbert D., *The Tax Situation in Illinois*, Chicago: Institute for Research in Land Economics and Public Utilities, Northwestern University, 1929.

[16] Lutz, *op. cit.*

[17] Adarkar, *op. cit.* Professor Shirras expressed the belief that " . . . a State which appropriates only a small portion of the gross income has much larger resources in times of necessity." (Shirras, G. Findlay, *The Science of Public Finance*. London: Macmillan and Co., Ltd., 1924, p. 130.) Silverman notes that " . . . if the tax has already reached such a level that it leaves the taxpayer just sufficient inducement to continue to produce, an increase in the tax beyond this level is liable to restrict the volume of income and therefore to cause the revenue from this source to decline." (*Op. cit.*, p. 83.)

[18] National Industrial Conference Board *Bulletin*, July, 1935 (Vol. IX, No. 7), New York.

doubtless have been higher and elasticity would have been lessened. Again, because a government must depend principally upon a continued yield of old taxes, moderation must be used in the imposition of tax rates in normal times.

Certain taxes, moreover, will allow an administrator to exact more sacrifice than will others, and each government unit should have the use of forms of revenue that will be responsive in the sort of emergency to which that government is most likely to be subject.[19] Thus to local governments, whose usual emergency is the business depression, the property tax is well suited because of the tendency of rates and assessments to lag behind values and incomes.

Finally, a government may gain elasticity in its budget by the use of caution in normal public borrowing. Thus the State of Arizona, in spite of a constitutional debt limitation of $350,000 customarily ran so far ahead of income, by the use of tax anticipation bonds, that the state found itself unable, during some months of the depression, to balance its budget or to sell any sort of security, and was compelled to issue so large an amount of warrants as to depreciate their value. A heavy debt not only exhausts credit as a source of temporary revenue, but increases the fixed tax burden. Even constitutional debt limitation may make for more flexibility in finance, by raising the value of temporary warrants.

The old discussion of whether or not a government, like an individual, must "cut the suit to the cloth," often misses an important difference between private and public finance. A government income resembles an insured income in that it is as assured as the collective income of the whole group of taxpayers. Most of the possible curtailments to the earning power of an individual do not threaten the state, for state income fails only if the general economic organization becomes impaired. The individual cannot save sources of income, and so, to give his budget some measure of flexibility, he must save money. A state, on the other hand, can usually not be entrusted to save money, but can save sources of revenue, and thereby prepare itself to meet emergencies.

[19] Adarkar, *op. cit.*, pp. 222–223. Lutz, *op. cit.*

Implications

Because elasticity is acquired only through additional sacrifice on the part of the taxpayer, it follows that the state's gain is the taxpayer's loss. The danger is that in an economy in which instability is the key note and business profit is the only stimulating force, an ability on the part of the state to command additional sacrifice in depressions may act to slow recovery. Elasticity in public revenue, in other words, tends toward inflexibility in private finance. In this matter the government, like any other preferred creditor, is primarily interested in the continued success and profitableness of the firm, and, like this preferred creditor, may find it expedient to make the tax burden more of a contingent charge as it becomes higher. From this viewpoint it appears that the present tendency toward taxes upon gross income may be of more than temporary significance, even though it leads away from elasticity in public revenue. Yet that this is not the complete answer to the problem is borne out by the fact that public demands for expenditure increase during a depression. One obvious solution is to keep normal taxes, like any other fixed charge, low enough during good times

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to be carried without business failure during depressions.

The concept of the tax burden as a fixed charge upon business is a useful modification of the conception of public expenditures as a method of apportioning the social dividend. Mr. Pigou has indicated that the proper height of public expenditures is that point at which the last tax dollar brings the same satisfaction to the community as would the same dollar privately spent.[20] An unskilled attempt to use this formula to weigh the tax burden at any one time may involve the danger of ignoring the impact of fixed public charges upon an unstable social dividend.

These principles apply, also, to the question of central control of local expenditures and indebtedness. It is somewhat difficult to prove that, during normal times, local public expenditures are more than the people desire, or to show that localities are incompetent to judge the amounts that should go for public service; but it is not so difficult to show that such localities have tended to increase the fixed burden of public charges, through short-sightedness, beyond the capacity or willingness of industry to bear them in a depression. It is possible to point out, moreover, that the proposal is not so much to regulate the small communities by the large as to regulate those two parts of a financial system most fixed in their burden—the property tax and the funded debt.

On the other hand, local governments do not appear to be the only ones to need a certain planned financial program. In the emergencies of the War and the depression, Federal and state governments fell back upon unused taxing power, but the question of elasticity looks always to future emergencies. Will we, in the coming period of better times, equip our revenue systems to be more, or less, responsive? The process in the past has been the relatively simple one of allowing expenditures and indebtedness to lag, by inertia, behind the price level or the economic development of the nation. This process, however, takes time and assumes a steady expansion of business, rising prices, a safe period between emergencies, and a strong conservative influence in politics. Some sort of long-time tax program would appear to be a desirable adjunct to this process, from the standpoint of both government and business.

[20] Pigou, A. C., *A Study in Public Finance*. London: Macmillan and Co., Ltd., 1928, chap. VII.

RECENT PUBLICATIONS ON BUSINESS CYCLES

BY JOSEPH L. SNIDER

THERE appear to be cyclical fluctuations in the literature of business cycles as well as in business itself. During the last prosperity phase, several years ago, writings in the field dealt predominantly with records of past cycles and with methods for forecasting future ones. During the present phase of depression the bulk of the literature has dealt with problems of controlling cycles. Thus, of the dozen recent books and pamphlets which are discussed in this review, the great majority are discussions of problems of control, only two or three are descriptive or historical treatments, and not one is concerned primarily with problems of forecasting.

In *Controlling Depressions*,[1] Professor Paul Douglas of the University of Chicago has presented a comprehensive program for the reduction of cyclical fluctuations. He has not shrunk from a consideration of highly controversial topics and, although many readers (including this reviewer) may find themselves in disagreement with numerous points of the program, the book is one which cannot fail to contribute to an appreciation of the problems involved in reducing business instability.

The book is divided into two parts, the first dealing with causes of business depressions and the second with methods of controlling them. The fundamental "generating" causes the author traces to two sources: (1) the failure of industry, because of monopoly and quasi-monopoly, to reduce prices commensurately with the reduction in costs resulting in the piling up of undue profits and the making of undue investment; (2) the failure of wages, salaries, and farm incomes to increase commensurately with the increase in output in the mass production industries.

In arriving at these two fundamental generating causes, Professor Douglas has unfortunately confined his analysis to the period leading up to the present depression. Moreover, additional causes of this depression should have been considered, as, for example, the Great War.

In presenting his recommendations for controlling depressions, Douglas first addresses himself to a consideration of changes in Federal reserve policy. He points out effectively the serious limitations, as to both restraint in prosperity and stimulation in depression, of changes in the rediscount rate and in the holdings of government securities by the Federal reserve banks. This leads him to consider the stabilizing possibilities of a managed currency which, because of recent developments, seems far less hazardous than before. In fact "we are in an admirable internal position for experimenting with a managed currency and we need be in no hurry to tie ourselves in an inflexible fashion to the chariot of gold."[2]

In regard to credit, the author argues that there should be a separation of two functions: (1) the creation or the manufacture of credit, and (2) the retailing of credit. The former should be in governmental hands; the latter

[1] Douglas, Paul H., *Controlling Depressions*. New York: W. W. Norton & Company, Inc., 1935. 286 pp. $3.00.

[2] *Ibid.*, p. 154.

should be left to private hands, inasmuch as the government could not handle the problem of *who* shall be given credit. Some of the important features of the plan involve the taking over by the government of the ownership of the Federal reserve banks; the buying up of government bonds by the Federal reserve banks and the issuance, in return, of Federal reserve notes; the existence of private banks of deposit where persons could leave money for safe keeping; the requirement of 100% reserve in cash behind deposits, and therefore the inability of the deposit banks to build up additional credit upon deposits.

One may be convinced of the aggravating effects upon business fluctuations of the expansion and contraction of credit by our existing banking system, and of the need for more effective methods of credit control than changes in rediscount rates and holdings of government securities by the reserve banks, without being impelled to the author's conclusion that the socialization of credit is a wise move for the United States. Sufficient reason for such dissent may be found in the great dangers involved in entrusting to a politically controlled body such enormous economic responsibility.

Another and somewhat similar recommendation is the proposal for the nationalization of numerous industries which have a tendency to monopoly. The monopolistic industries are responsible for "sticky" prices which, in turn, have contributed to the maladjustment between costs and prices. There is no reasonable probability of regulating these monopolistic industries, in the author's opinion; rather, the regulatory commissions are controlled by the industries. Public ownership becomes, therefore, the only alternative. The public utilities, the railways, the electric and gas, steel, aluminum, electrical machinery, and heavy chemical industries must be socialized in order that competition may work effectively in the small-scale industries which are adapted to competition. It might be desirable, to be sure, that the actual operation of the industries be carried on by private management with due protection as to rates, etc.

One of the strongly urged recommendations is a program of public works. The public works program of the present administration has been "eminently sensible," the money has, in the main, been "wisely allotted, and, so far as human powers permit, honestly expended." Professor Douglas urges as the next step in a public works program a large housing and slum clearance enterprise, "a direct frontal attack by the government upon the problem of housing for the low income groups." But it is necessary to reduce the exorbitantly high building costs for materials, labor, and land.

Professor Douglas places too much stress, in the reviewer's opinion, on the practicability of spending our way out of depression. Although it may be admitted readily that no adequate test of public works as a "balance wheel" has yet been made in this country, or in any country for that matter, it is unlikely that our political bodies will be able to postpone in good times a sufficient volume of public works to constitute a substantial stored-up need in depression. An elaborate public works program during depression, therefore, runs the serious risk of overbuilding. Moreover, the effect upon private enterprise should not be overlooked. Elaborate programs for government spending have discouraged private initiative dur-

ing this depression, and in all probability will do so again.

In a chapter on wage policies and depressions it is maintained that wage rates during prosperity must rise more than the cost of living, because it is essential that labor should not merely maintain the same real wages but rather that its *share* of the national income should be maintained. In order to bring this about, it seems probable, in the author's opinion, that such government control over minimum wage rates as was provided for under the NRA should be retained. A strong labor movement would also help, as well as a rather high excess profits tax on corporate earnings. These taxes could be used either to pay an outright consumer's dividend to the great masses of the population if their incomes lagged seriously behind the advance in productivity or, better still, to employ labor in furnishing community services. The wise wage policy during depressions would refrain from insisting upon rigid maintenance of wage rates. Wages must give ground in order to prevent undue pressure upon businesses operating under the profit system. In his discussion of wage policies as well as at other points in books, Professor Douglas is governed too largely by a purchasing power theory of business cycles. He very much underestimates the importance of the enterpriser's prospects and frame of mind as a determining factor in cyclical fluctuations.

Unemployment insurance is also urged, not only for the purpose of lessening distress, but also as a means of stabilizing industry. A well-devised system of insurance would promote the transfer of purchasing power from prosperity to depression. Reserves would be stored up in good times and paid out in bad times. The author recognizes, however, that no insurance system can completely take care of all the needs which unemployment creates.

By his brief, readable book, *The British Way to Recovery*,[3] Professor Herbert Heaton of the University of Minnesota has broadened the perspective of the American student of recovery problems, a notable service. The book is a description, rather than an evaluation, of the recovery programs in England, Australia, and Canada.

The British problem of recovery was primarily to regain ground lost in her export markets and to replace some of that loss by expanding production for the home market. This problem was, of course, not created in 1929; it was only intensified.

The searches for solutions of Britain's recovery problem, made before 1931, were in general of two kinds. The first was directed toward the removal of external obstacles, such as the reparations claims, currency muddles, interallied debts, and the rush toward economic nationalism. The second was directed toward the "rationalization of British industry." This involved a reduction in the number of small units, in the number of middlemen, and in the improvement of equipment and methods of management. The railroads, the coal industry, and the electric power industry were subjected to rationalization. But much of the good done by these measures was undone by the return to the gold standard at prewar parity in 1925. The author believes there is a good case for declaring that the controllers of Britain's credit sought to maintain or win back the financial supremacy of London at the expense of British industry.

[3] Heaton, Herbert, *The British Way to Recovery*. Minneapolis: The University of Minnesota Press, 1934. 184 pp. $2.00.

One of the clearest and most valuable impressions from Professor Heaton's book is that the British government did not let nature take its course in lifting the country out of depression. When the financial crisis of 1931 was over, the government and the banks pursued a policy intended to provide cheap and abundant credit for the state and for private enterprise. The government placed an embargo on capital issues to foreign borrowers. The Bank of England reduced its rate from 6% to 2%. It also began to buy securities heavily. The Exchange Equalization Account was set up in April, 1932, with a fund of £150,000,000, to check the fluctuations in foreign exchange rates. Perhaps the most far-reaching changes in British policy came with the final abandonment of free trade and the adoption of a protective policy mitigated by imperial preference. Temporary protection was given to several products in November, 1931, and in February, 1932, the real tariff was imposed. Many measures were also taken to improve the position of British agriculture—import quotas to prevent the glutting of the market, marketing schemes, subsidies, and better farming methods.

Turning from Britain to Australia, Professor Heaton records that early in 1931 the banks abandoned their attempts to peg the exchange rate near parity with sterling, which was then still on gold, and *real* wages were reduced 10% by the Federal Arbitration Court. There followed, shortly, an extension of wage cuts to pensioners and public employees and reductions in all possible expenditures. Moreover, a reduction of 15% in interest on internal public debt was carried through. Laws were passed to reduce mortgage rates by 22½%. These attempts to check the drift in public finance restored Australia's credit rating abroad, while the expansion of exports, combined with the decline in imports, restored the country's capacity to meet its external debts. Part of the overseas debt was converted with a substantial saving in interest charges. Australia also followed certain inflationary procedures. In addition to permitting its currency to depreciate in foreign exchange, there was a substantial increase in the floating debt from the sale of treasury bills.

Canada's depression problems and attempts to cope with them have had no peculiar features. Although the average Canadian may have the impression that the government has done very little to stimulate revival, a great deal has been attempted. The tariff was raised quite early in the depression, taxes have been much increased, a central bank has been established, an agricultural marketing scheme was put into effect, mild inflation of the note issue has come, and elaborate relief plans for debtor farmers have been made.

Late in 1933, the Committee of the Economic Science and Statistics Section of the British Association for the Advancement of Science appointed a committee to prepare a record of industrial and financial changes in Great Britain during the present world depression. The volume *Britain in Depression*[4] appeared approximately two years later as the committee's report. The aim of the book is to record the principal events and to indicate sources of data rather than to provide interpretation. Some twenty different authors have contributed the various chapters, which are separated into two groups.

[4] *Britain in Depression*, prepared by a research committee of the Economic Science and Statistics Section of the British Association. London: Sir Isaac Pitman & Sons, Ltd., 1935. 473 pp. $3.00.

The first group presents general discussions of currency and banking, industrial relations, and the background of developments during the post-war period. The second, and much the larger, group of chapters consists of separate treatments of all the leading British industries. The book is essentially a reference work, as far as American students are concerned, but as such should prove helpful to the investigator of special topics.

Of great value to the student of business cycles and of economic history is the substantial volume *Fluctuations in American Business, 1790–1860*,[5] in which Professors Smith and Cole present the results of their extended researches over a considerable period of years. The book is primarily a presentation of many statistical series, with extended comments thereon, measuring changes in commodity prices, stock prices, sales of public lands, interest rates, and to a lesser degree—because of scarcity of data—the volume of trade. It also presents a limited amount of descriptive material on the general economic developments of the period.

The student of business cycles will be especially interested in the authors' discovery of a sequence in movement of stock prices, commodity prices, and interest rates during the years 1790–1860 similar to the sequence previously found by other investigators for later periods.

In the book *Public Works in Prosperity and Depression*,[6] Dr. Gayer has presented a great deal of carefully compiled statistical information on the volume and financing of public works enterprises by the Federal Government, the states, and local political bodies. The volume is primarily factual, with secondary emphasis given to the economics of public works and the development of a desirable public works program for the country.

The author points out that, although long advocated for the purpose, it was only during the present depression that an attempt was made on a large scale to expand public construction in order to stimulate business. But, despite the unusual efforts exerted, public works in the aggregate shrank very substantially. Although Federal outlays grew rapidly, their increase was more than offset by the steady decline in the public works expenditures of states, counties, and municipalities. These facts, however, in the opinion of the author, do not afford an adequate criterion for passing judgment on the merits and defects of the principle of planned flexibility in public works, for the element of advance planning was essentially absent. What was done was in the nature of an emergency measure. The depression emphasized the necessity of prior planning and the provision of credit reserves.

Very brief comment will suffice for each of three other books. Mr. Harold Fisher, an English woolen manufacturer, concludes in his book *The Inevitable World Recovery*[7] that in 1933, when the "incubus" of the old gold standard was thrown off, world economic history entered a new phase which, "measured by the depths from which it rises, will go far further than any similar movement ever known." Mr. Emil O. Jorgensen, in his book *The Stagnation of*

[5] Smith, Walter B. and Cole, Arthur H., *Fluctuations in American Business, 1790–1860*. Cambridge: Harvard University Press, 1935. 195 pp. $5.00.

[6] Gayer, Arthur D., *Public Works in Prosperity and Depression*. New York: National Bureau of Economic Research, 1935. 460 pp. $3.00.

[7] Fisher, Harold, *The Inevitable World Recovery*. Garden City, New York: Doubleday, Doran and Company, Inc., 1935. 253 pp. $2.00.

Industry: Its Cause and Cure,[8] urges the "single tax" as the cure. In *The Profit Mystery and Wealth Illusion*,[9] Mr. Clayton D. Browne recommends

> . . . a method by which everyone, from bootblack to multimillionaire would be compelled to spend his income for material things; lands, buildings, labor, services, goods, or stocks. Investment *in new* bonds, mortgages, or private debts would be prohibited. A tax of 90 per cent would be levied on income used for any additional lending above the present indebtedness. All present indebtedness would be allowed to stand and when any of it was paid, the money could be loaned again forever. This would give a monopoly of lending to those who had money loaned out. It would be a guarantee that the interest would be paid forever, a lender's PARADISE, and a menace to no one.[10]

In addition to the books which have been discussed, four recent pamphlets should be included in this review. Colonel Leonard P. Ayres of the Cleveland Trust Company concludes that "trade cycles are mainly caused by changes in the volume of purchases of durable goods by business enterprises, actuated by changes in the prospects for profits."[11] The difficulty is much aggravated by the wide price swings of war and post-war periods.

The importance of war as a cause of depression is the special theme of a recent pamphlet issued by the World Peace Foundation.[12] In very brief compass, the author, Mr. J. B. Condliffe, points out effectively the disorganized condition of production, the breakdown of credit and financial systems throughout the world, and the very great reduction in world trade as results, very largely, of the Great War. International coöperation, in an effort to remove the serious obstacles, is the way to world recovery.

Sir Henry Strakosch, in a pamphlet *The Road to Recovery*,[13] published simultaneously in England and in America, grapples with the problems of exchange stability and the restoration of the international gold standard. He dismisses on practical grounds the idea of a managed international paper standard and proceeds to examine the conditions in which it would be safe to reëstablish an international gold standard. Among these conditions is a reasonable assurance that violent fluctuations in the purchasing power of gold will be avoided. The prospect for achieving this condition is discouraging in view of the absence of central bank coöperation, but he believes that progress toward it can be made if the sterling area and the United States would coöperate. Moreover, he is of the opinion, quoting President Roosevelt, that the United States aims to bring about stability in the purchasing power of gold.

Finally, a pamphlet on a more specialized topic may be considered. *The Building Industry and Business Cycles*[14] presents the conclusions of a doctoral research by William H. Newman. The findings in part verify the results reached by other investigators, and in part are new. Thus, the author has found major cycles in building activity

[8] Jorgensen, Emil O., *The Stagnation of Industry: Its Cause and Cure*. Elkhart, Indiana: James A. Bell Company, 1935. 247 pp. $2.00.

[9] Browne, Clayton D., *The Profit Mystery and Wealth Illusion*. Dallas, Texas: Analytic Publications Company, 1935. 176 pp. $2.00.

[10] *Ibid.*, p. 162.

[11] Ayres, Leonard P., *The Chief Cause of This and Other Depressions*. Cleveland: The Cleveland Trust Company, 1935. 52 pp.

[12] Condliffe, J. B., *War and Depression*. Boston: World Peace Foundation, 1935. 30 pp. 25 cents.

[13] Strakosch, Sir Henry, *The Road to Recovery*. New York: Economic Forum, Inc., 1935. 70 pp. 50 cents.

[14] Newman, William H., *The Building Industry and Business Cycles*. Chicago: The University of Chicago Press, 1935. 73 pages. $1.00.

lasting from 15 to 20 years, as well as cycles of shorter duration. He also has verified the tendency for building to precede general business in the timing of cyclical fluctuations.

Among the factors which are responsible for fluctuations in building, changes in the prices of materials and labor were found to be comparatively unimportant. Long-term financing conditions, particularly the availability of funds, have played a vital rôle in determining the minor cycles, but have been comparatively unimportant with respect to major cycles. Statistical support was presented for the hypothesis that building activity is greatly affected by population movements.

Conclusion. Proposals for business cycle control carry the principal emphasis in recent writings on business cycles, but the most significant contributions are to be found in a few descriptive and historical publications of high quality. With some exceptions, the proposals urged as means of control are, in the present writer's judgment, uneconomic and unwise; such is perhaps to be expected in a period of great stress.[16]

[16] The book list on page 256 includes a few additional books in this general field which were not available when this review was prepared.

CAPITALISM UNDER FIRE: RECENT BOOKS ON ECONOMIC RECONSTRUCTION

BY J. PHILIP WERNETTE

RECENT years have witnessed increased criticism by many persons of the present economic system, or the capitalist system, as some prefer to call it. Prior to 1929, critics of the economic system said little about depressions. Their principal accusations were these: the unequal and unfair distribution of wealth; the inefficient methods of producing and distributing goods; and the selfishness, cruelty, and greed of the system. To prove these accusations was not easy; the task of the critic was hard.

The coming of the great depression has not only made the task of the old-time critics easier, but it also has produced a new crop of critics. Sober, thoughtful persons, appalled by the length and depth of the depression, are moved to ask whether a system subject to such paralytic attacks should be continued unchanged and, indeed, whether it *can* endure unchanged.

Some writers maintain that capitalism can be patched up at this point and perhaps elsewhere also. Others insist that capitalism is inevitably subject not only to depressions but to so many other evils that the entire system should be scrapped in favor of some form of economic collectivism. It is impossible to draw a sharp line between these categories; the writers occupy positions along the line between relative conservatism and relative radicalism. Mr. Stuart Chase, for example, might be classified in group one (patching it up), but his proposals for collectivism are so sweeping that he could be included in the second group (scrapping it) even though he neither considers himself a socialist or communist, nor would be labeled as such by socialists or communists, unless possibly by the English Fabian socialists.

Most critics of the present economic system want, in varying degrees, more government regulation and ownership. Indeed, there has been current during recent years a pretty general notion that the doctrine of *laissez faire* was dead. *Laissez faire*, however, has a new champion in the person of Mr. Lewis W. Douglas, whose Harvard Godkin Lectures of last May now appear as a small book entitled *The Liberal Tradition*.[1]

In Chapter I, "The Sins of the Past," Mr. Douglas lists the following as the four dominant characteristics and fallacies of the "degenerate capitalism" of the 1920's in the United States: (1) exorbitantly high tariffs, (2) governmental sanction of illegal price fixing, (3) an ill-advised managed currency, and (4) too many rigidities. Having excoriated the actions of the Republican Party, Mr. Douglas criticizes the socialists, communists, and economic planners in Chapter II, "A Planned Economy and the Oppressive State." Mr. Douglas makes many penetrating criticisms of the collective state, but some of his statements are open to question. He himself says in the preface, "It may very well be that in the second lec-

[1] Douglas, Lewis W., *The Liberal Tradition*. New York: D. Van Nostrand Company, 1935. xxiii + 136 pp. $1.50.

ture the criticisms of a Collective State are too severe, at least in what may be its initial stages. And yet it seems to me that in its final development it must be approximately as pictured."[2]

Mr. Douglas turns his back on the Democratic Administration in Chapter III, "Dictatorship and a Fiscal Policy," in which he presents the usual arguments concerning the ill effect of budgetary deficits and raises the specter of inflation. Finally, having denounced Republicans, socialists, communists, economic planners, and Democrats, Mr. Douglas delimits the sphere of Federal authority and proposes his own program. "The postulates to a smoother working of a liberal economy," he states, "are it seems to me: first, free competition and flexibility of prices; second, mobility of labor and of goods; third, flexibility of costs; fourth, a modification of our tariff policy to effect and maintain (a) a balance between agriculture and industry, (b) a sound currency, and (c) escape from despotism; fifth, a greater use of the 'Compact Clause' of the Constitution and a greater exercise of local responsibility; sixth, a reformed banking system; and, finally, a responsible fiscal policy which will assure stability of exchanges."[3]

The opening paragraph of *The Great Change*,[4] by Richard T. Ely and Frank Bohn, reads thus:

> The changes began with the use of machines in place of tools, and with the general use of applied science in place of rule of thumb. During the hundred and forty years since the inception of the Industrial Revolution in this country, we Americans have been always replacing the old with the new. The new way of life has produced new habits of thought about the conditions of life. These things are now coming to a climax in the reconstruction of our social order. We call this transition the Great Change.

There follows a comparison between the old rural and village life of America and its modern urban industrial life. Written largely by Professor Ely, the account begins with a faintly wistful account of his life on the farm as a boy and his visits to his Jack-of-all-trades grandfather, who was born in 1802 and to whom, thanks to his almost self-sufficing life, the panic of 1837 meant nothing. The authors contrast this rustic and peaceful life (in which certain inconveniences go unmentioned) with the modern hurly-burly. Today's city life is characterized by a feverish tempo of working and playing, by slums, noise, confusion, political corruption, commercial cunning, insecurity, unfriendliness, and machine production.

The argument meanders a good deal after the first few chapters, and the bearing of the subject matter of many of the following chapters on the theme is not made very clear. The ambitious scope of the work is indicated by some of the topics touched on in these later chapters, including socialism, communism, fascism, prosperity, depression, recovery, labor and labor unions, money and banking, debts and taxes, nationalism and internationalism, and darkness and dawn. These chapters are mainly descriptive and the treatment of their subjects is rather superficial.

The question to which the authors address themselves, "Is our modern urban economy really good, all things considered?" is important. The authors have expressed their doubts, but have

[2] *Ibid.*, p. viii.
[3] *Ibid.*, p. 105.

[4] Ely, Richard T. and Bohn, Frank, *The Great Change*. New York: Thomas Nelson & Sons, 1935. 373 pp. $2.00.

been vague in suggesting what to do about it. They urge the need for "national regeneration" and control over machines; and offer the general suggestion that we need new ways, new laws, and new disciplines. They are right, of course; the remaining problem is what new routines should be adopted.

The Rt. Rev. Msgr. John A. Ryan, Professor of Moral Theology and Industrial Ethics at the Catholic University of America, asserts in *A Better Economic Order*[5] that capitalism has been committing slow suicide because it has assumed that no efforts need to be made to put purchasing power into the hands of those who would use it in sufficient volume to take products off the market. Capitalism has assumed that adequate consumption would follow automatically upon unlimited production. The few rich people, argues Father Ryan, have had enormous incomes, most of which have been spent, if at all, on capital goods, and the result has been overproduction in the sense that there has not been sufficient purchasing power in the hands of those who would spend it on current consumption. This thesis, the author says frankly in the preface, is the same as Mr. John A. Hobson's familiar proposition.

The author argues that the purchasing power of that part of the population that desires to consume much larger quantities of goods be expanded in two principal ways: (a) by raising the real income of the farming groups to a level approximating that which obtained before the Great War; (b) by increasing the share of the product going to the wage-earning classes. Father Ryan approves the processing tax as a means of accomplishing the first of these two aims. Of the second he states that the most effective immediate method of increasing the purchasing power of the workers would be the general establishment by law of a thirty-hour week, with no reduction in existing wage rates. Permanent prosperity is to be achieved by two complementary actions: The first is high taxes on incomes and inheritances, which will diminish the surplus available for investment. The second is a system of public works, which will increase the fund of actual purchasing power.

Apparently Father Ryan believes that if depressions were eliminated capitalism would need only a little additional improvement. He therefore rejects fascism, socialism, and communism.

"Happily," says the author, "a constitution for a better economic order can be found outside of collectivism. Indeed, it would be the antithesis of collectivism, no less than that of capitalism. Such a constitution has been outlined and recommended by Pope Pius XI in his encyclical 'On Reconstructing the Social Order.'"[6] The institutional change which the Pope recommended is "the reëstablishment of occupational groups."[7] These would include both employers and employees, both capitalists and laborers, and would adopt and adapt the principle and spirit of the medieval guilds. The occupational group would be empowered by law to fix wages, interest, dividends, and prices, to determine working conditions, to adjust industrial disputes, and to carry on whatever economic planning was thought feasible.

Father Ryan does not discuss in detail the operation of these proposed oc-

[5] Ryan, John A., *A Better Economic Order*. New York: Harper & Brothers, 1935. ix + 194 pp. $2.50.

[6] *Ibid.*, p. 177.

[7] *Ibid.*, p. 179.

cupational groups and the problems which they would face. This is a subject that might well be analyzed at length rather than being offered as a simple panacea.

Whatever else may be said of the books which Mr. Stuart Chase has written, surely no one could say that they are dull. His new one, *Government in Business*,[8] is no exception. His style is crisp, vivid, and brisk. The book is easy reading in another respect. Mr. Chase is certain; there are no troublesome doubts in his mind; there are no hesitant conclusions and qualified answers. Everything is either black or white.

In the opening chapters of this book, Mr. Chase describes the tremendous growth of governmental activity in business, in the United States, Russia, Germany, Italy, Sweden, and Canada. From this exposition he turns to the question: What is the proper sphere of government in business in the United States? Mr. Chase advocates extension of governmental business activities in two of three general fields. The first of these includes major processes and commodities so essential to the consumer as to be legitimate public business; the second, underlying industries and services which make the first possible. Here public business should be dominant at least to the extent of restraining private enterprise from twisting or checking the flow. The third field, luxuries and preferences, must not be dominated by the state. The long classification of industries in these two groups and a third group—those not to be subject to government control—I found puzzling and unconvincing.

In Chapter XV Mr. Chase discusses the comparative merits of public administration and private administration. I cannot tell from his incomplete observations what his opinion is as to their comparative efficiency at present. Nevertheless, he expects public business to be superior in the future to what it is now, since he regards necessity as the mother of administration.

But will this be true? To illustrate with Mr. Chase himself as an example: Private industry has availed itself of his professional accounting services. There are many such able men in the service of both private and public business. But the crucial questions are two: In the long future, which is more likely to put such men in the positions of authority, and, under which system will they be more free to use their talents for the general good?

In *Capitalism and Its Culture*,[9] Professor Jerome Davis presents the case against capitalism, which includes: concentration of ownership and control, corruption, waste and want, inefficiency, the evils of holding companies, financial manipulations, stock pools, nonvoting stock, watered valuations, tax evasion. He scores the wastes and high costs of distribution, the wastes and deception of advertising, and the victimization of the consumer. He is critical of the system on philosophical grounds: that it glorifies selfishness, inculcates materialistic standards, operates under a regime of false values, encourages hypocrisy (*e.g.*, going to church to get business), dominates churches and religion, fosters prostitution, gambling, crime, and disregard for the rights of other persons, enslaves the press, the radio, schools, universities.

The indictment, in short, is sweeping and savage. It is liberally buttressed

[8] Chase, Stuart, *Government in Business*. The Macmillan Company, 1935. 296 pp. $2.00.

[9] Davis, Jerome, *Capitalism and Its Culture*. New York: Farrar & Rinehart. xvii + 573 pp. $3.00.

with evidence; facts and figures are given and names named. It is, of course, evidence for the prosecution and it is given boldly. Much of the argument and certain of its implications and innuendoes would be weakened if it were subjected to cross-examination.

Professor Davis sums up and considers future changes in the final chapter:

> In this volume we have tried to sketch some of the more important conditions which exist under capitalism. It should be emphasized again that there has been no effort to prove conclusively that all the conditions enumerated are due solely to capitalism. It is contended, however, that some of them are the products of the capitalistic system and can hardly be eliminated so long as this profit-motivated economy remains. . . . All students of this "order," except the reactionaries and diehards, are agreed that changes must now be made. The only question is, in what direction? It is not the purpose of this book to lay down a concrete blueprint of the society of the future.[10]

We are left uninformed as to whether Professor Davis expects and wants some sort of collective economy or an economy dominated not by the profit motive but by motives such as the wish to serve humanity, the joy of work itself, or the satisfaction of creativity, which he mentions on page 234. This really is the crucial question. Most persons are agreed that there are serious evils in the present working of the economic system, although they would not necessarily agree with all of Professor Davis's description of the evils. Few among this great majority would assert that none of these sad features can be eliminated. They do disagree, however, about which of them can be ended and how it can be done.

Dr. Harry W. Laidler, Executive Director of the League for Industrial Democracy, has written another substantial, well-documented book, *Socializing Our Democracy*.[11] In this factual, analytical, and philosophical volume three principal subjects are discussed: (1) the collapse of capitalism; (2) the transition from capitalism to socialism; and (3) the structure and operation of the socialist state.

The familiar evils of capitalism are discussed briefly, and Dr. Laidler concludes that the trends mentioned by Marx and Engels are bringing increasingly near the breakdown of the capitalist order. They will not, he asserts, as some Marxists used to imagine, bring about socialism with automatic precision. The breakdown of capitalism may be followed as elsewhere by a ruthless dictatorship. If socialism is to follow the present order, its advocates must dedicate to the movement their most devoted, their most intelligent, their most powerful efforts.

"The essential difference between socialism and communism," says Dr. Laidler, "lies not in goals but in tactics. . . . As to means of attainment of these goals, however, there is a wide divergence of opinion."[12] Communists believe that the collective state cannot be brought into being by peaceful means and must and can be introduced by violence. Dr. Laidler asserts the opposite, that violence cannot succeed (because military and police strength are on the side of capitalism), and that peaceful means, balloting, must and can create the socialist state. He favors extension of state ownership and operation of industry, the present owners

[10] *Ibid.*, p. 512.

[11] Laidler, Harry W., *Socializing Our Democracy*. New York: Harper & Brothers, 1935. x + 330 pp. $3.00.

[12] *Ibid.*, p. 95.

presumably to be remunerated by being paid terminable annuities.

The remainder of the book is devoted to a valiant attack on the enormous problem of blue-printing the future socialist state. The titles of some of the chapters indicate the scope of the treatment: Public Ownership, Voluntary Coöperation, Democracy in Economic Government, Incentives and a Socialized Society, Making Industry Pay Under Socialism, Guarantees of Security, Health and Recreation, A New Political Structure, The New Education, Artistic Effort, and The Family.

Dr. Laidler would have the socialist state adopt the familiar devices of a price system and a money system and, I take it, use rent, interest, profits, and wages as part of the accounting and administrative system in determining what to produce and how to produce it. After discussing alternative methods of paying labor and splitting up the national dividend, he recommends a flexible policy: "The equality, the deeds and needs principles, however, should all find their place in a socialized order. That principle or combination of principles should be applied, which seems most likely to stimulate the finest endeavor and promote the good and happiness of the greatest number."[13]

Two important issues connected with the debate of Capitalism versus Socialism are these: first, the method of paying workers and the problem of incentives; and, secondly, the technique of selecting those who are to have authority and the problems connected with this technique. It seems to me that Dr. Laidler has argued his case with respect to the first with great skill. I wish that Dr. Laidler had addressed himself to the other matter in the same careful fashion. It is not enough to talk about those who will *obey* orders in the socialist state. What about those who *give* orders? How are they to be selected?

"Works of economics by non-professional economists," writes Mr. John Strachey in the preface to *The Nature of Capitalist Crisis*,[14] "are justly suspect. . . . The greater number of amateur economists have either rediscovered truths which were already known, though not to them; or they have fallen into errors. . . . " He might have gone on to say that, because of their freedom from formal training and unfamiliarity with orthodox ideas, they may avoid the standard errors in the books and discover some new, valid theories.

Mr. Strachey really is unduly modest in classing himself as an amateur. If he has a shortcoming as a scientist, it is that he is an apostle. Surely no one is a Simon-pure amateur who refutes (as Strachey does in Part I, "Capitalist Theories of Crisis") in detail Major Douglas, J. A. Hobson, Irving Fisher, and Friedrich Hayek, and who weaves in brief evaluations of Keynes, Hawtrey, Barbara Wooton, Durbin, Robbins, and others. The amateur touch is more in evidence in Part II, "From Political Economy to Economics."

In Part III Mr. Strachey explains and defends the Marxian labor theory of value. This was a surprise. I had thought that modern Socialists and Communists had relegated this theory to the position of a sort of war cry or college cheer. Parts IV and V ("Marx's Theory of Capitalist Crisis" and "The Theory Applied") follow familiar lines and no attempt is made

[13] *Ibid.*, p. 200.

[14] Strachey, John, *The Nature of Capitalist Crisis*. New York: Covici, Friede, Inc., 1935. vi + 400 pp. $3.00.

to utilize modern precision techniques in either analyzing or evaluating the Marxian theory.

In *The Coming American Revolution*[15] Dr. George Soule presents an interesting and provocative argument. Moderate in tone but rather dogmatic on some debatable points, it gives the impression of being less well integrated and more inadequately digested than would be appropriate for a scientific handling of his theme.

In Part I, "The Nature of Revolution," Dr. Soule gives an historical account of the English Puritan Revolution, the American Revolution, the French Revolution, and the Russian Revolution. The actual revolutionary break, says he, is not really the revolution; it is merely the culmination of a process.

> At length there arrives a revolutionary crisis which can be recognized by two main characteristics. First, the old ruling classes are unable, because of their own weakness under the circumstances, to carry on successfully. . . . Second, the rising classes have already achieved substantial power, which they need only to consolidate and exercise in order to supersede the rulers. Both elements are necessary. . . . [16]

Part II, "Changes Under the Surface," includes a discussion of machines, debts, rigidities, and foreign trade. Dr. Soule concludes that the old system is cracking; something new is rising to take its place; and the first essentials of the long revolutionary process are present.

Part III, "The Crisis of the Thirties," is devoted to an historical account and analysis of the causes of the depression and the Hoover and Roosevelt recovery programs. This is, of course, a highly controversial subject, on which the learned doctors disagree. Many persons would object to Dr. Soule's emphasis and analysis. His conclusion is: "The first nebulous efforts to undertake social planning thus ran afoul of the realities of capitalism."[17]

In Part IV "The Coming Revolution," Dr. Soule offers a forecast but admits the difficulties of predicting in the social sciences. He says:

> . . . it would appear that a revolutionary period has begun, but it is still far from its climax. . . . It is clear that we are not now in the critical period of revolution. What the depression of the thirties gave us was an excellent foretaste, however, of the aspect that crisis will assume if it does come. . . . Capitalism comes out of this crisis the victor, but in the long run weaker both physically and morally. Some time in the future—perhaps not for another generation or two—there is likely to occur another serious breakdown of capitalism. If by that time the ferment of ideas has done its work and the rising classes have attained status and confidence, the two essential ingredients of the revolutionary mixture will be present. . . . After that, who knows what will happen?[18]

Dr. Soule's conclusion is thus much less definite and less "radical" than the earlier part of his argument would lead the reader to expect. The earlier argument was that the revolution is on its way. The conclusion, however, is merely that some type of revolution may come at some time in the future. This is an eminently "safe" conclusion; in fact it is so carefully qualified that its truth is incontrovertible.

Thus to the scores of books previously written are added eight more

[15] Soule, George, *The Coming American Revolution.* New York: The Macmillan Company, 1935. x + 314 pp. $2.50.

[16] *Ibid.*, p. 69.
[17] *Ibid.*, p. 260.
[18] *Ibid.*, pp. 300 ff.

dealing with the problem of the proper sphere of the state in relation to economic activity. Yet Mr. Stuart Chase prefaces his *Government in Business* with the statement, "No formal bibliography has been prepared because there are no books devoted primarily to this field, or none that I could find." There are, it is true, few books devoted primarily to this subject, but there are many in which the subject is discussed. A bibliography appended to a study made some years ago by the reviewer contains 69 titles. Dr. Laidler's bibliography includes 170 books. This mass of writing testifies at once to the interest in, importance of, and disagreement concerning this question.

The problem is not solved by the appearance of these eight books; nor will disagreement disappear forthwith. Adherents to the various shades of opinion may find their beliefs strengthened by certain volumes, may scoff at others. Readers who have not yet made up their minds will find any of these books interesting and provocative, although perhaps none will be found to be convincing beyond shadow of doubt. But can mere analysis and argument give a final answer? Perhaps in the long run such experiments as the New Deal, conservative England, the Italian Corporative State, and Soviet Russia may be of more scientific value than all the words that have been written on these controversial subjects.

[19] The following book list includes a few additional books in this general field which were not available when this review was prepared.

BOOK LIST

(American Publications, August through December, 1935)

Accounting and Insurance

Alexander, William. *My Half-Century in Life Insurance.* New York: Harper & Brothers. 233 pp. $3.00.

Hanson, Arthur Warren. *Problems in Auditing.* Second edition. New York: McGraw-Hill Book Company, Inc. 573 pp. $5.00.

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